The Dueling Transferors Problem in Generation-Skipping Transfer Taxation

*Austin Bramwell and Sean R. Weissbart**

Abstract: Whether a transfer of property is subject to generation-skipping transfer ("GST") tax depends in part on the identity of the individual who is considered the "transferor." Yet a deep uncertainty as to the identity of the transferor may arise when a beneficiary of a trust assigns his or her beneficial interest to another. Taxpayers, commentators, and the Internal Revenue Service have proposed three possible theories for resolving the question of who is the transferor in those circumstances. A careful analysis of relevant authorities reveals that only one of these theories – namely, that an assignment of a beneficial interest has no effect on the identity of the transferor of the underlying trust property – is correct, while the others are not only technically misguided but, in some cases, threaten to undermine the very integrity of the GST tax. The Internal Revenue Service can and should resolve the dueling transferors problem by issuing a public ruling setting forth the correct analysis.

* Austin Bramwell is a partner in the Trusts & Estates group of Milbank Tweed Hadley & McCloy LLP in New York and an Adjunct Professor of Law at the New York University School of Law. Sean R. Weissbart is an associate in the New York City office of Morris & McVeigh LLP, where his practice focuses on trusts and estates, and an Adjunct Professor of Law at Fordham University School of Law. The authors thank Prof. Jerome M. Hesch, Prof. Grayson M.P. McCouch, and Joy Spence for their comments and insight.

Generation-skipping transfer ("GST") tax planning depends crucially on identifying the "transferor" of property held in trust. Surprisingly, however, it is not always obvious which individual should be considered the "transferor." In particular, if a beneficiary of a trust assigns his or her interest to another, whether by gift or by sale, two individuals could both plausibly be identified as the transferor of the underlying trust property. Which of the two "dueling transferors" should prevail is one of the great mysteries of the GST tax.

For a number of reasons, the dueling transferors problem is challenging to resolve. Foremost, there is a paucity of authorities directly addressing the issue. Only one, obscure regulation directly addresses the GST tax consequences of an assignment of a beneficial interest. That regulation, unfortunately, is open to multiple, conflicting interpretations. No other binding authority addresses the dueling transferors problem, although the Internal Revenue Service (the "Service") has discussed it in a handful of private letter rulings. The problem also arises in a number of different contexts. Beneficial interests come in a wide variety of forms and can be assigned either gratuitously or for consideration. The varying contexts in which the problem arises make a general solution to the problem elusive. Finally, as discussed below, the solution that most feel, at least initially, to be intuitively correct is at loggerheads with the policies underlying the GST tax.

The authorities and scholarship[1] that have addressed the problem suggest three possible solutions, which are illustrated by the following hypothetical:

> Example 1: Grandfather ("G1") creates a trust under G1's will whose net income is directed to be paid annually to G1's son ("G2a"). Upon G2a's death, the remainder is payable to G1's daughter ("G2b") or G2b's estate. G2b irrevocably assigns G2b's remainder interest to G2b's son ("G3") for no consideration. The assignment is effective under local law.[2]

Here, G3 is a so-called "skip person" with respect to the transferor of the trust, G1.[3] Normally, where a trust terminates in favor of a skip person, the termination is a so-called "taxable termination" subject to GST tax.[4] But in this case, G3 received the remainder interest from G2b, and G3 is not a skip person with respect to G2b. The question

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1 Perhaps the most thorough and judicious discussion of the dueling transferors problem to date can be found in CAROL A. HARRINGTON ET AL., GENERATION-SKIPPING TRANSFER TAX ¶ 9.12(5) (2d ed. 2001).

2 Assignments of beneficial interests are frequently prohibited by "spendthrift" clauses in the governing instrument or by statute. *See*, *e.g.*, N.Y. EST. POWERS & TRUSTS LAW § 7-1.5(a) (McKinney 2015). It is generally possible, however, for the settlor to make beneficial interests in trusts assignable, as, indeed, was traditionally the default rule. *See* Restatement (Second) of Trusts § 132 (1959). For a state-by-state analysis on the assignment of beneficial interests in trust, *see also* 11 GEORGE G. BOGERT ET AL., THE LAW OF TRUSTS & TRUSTEES § 188 (2d ed. 1979 & Supp. 2011).

3 A "skip person," in the case of an individual, is someone who occupies a generation two or more generations beneath that of the transferor. I.R.C. § 2613(a).

4 A "taxable termination," as discussed in part I of this article, is one of three types of events that are subject to GST tax. In general, a taxable termination is the termination of an interest in property held in trust, unless, immediately after such termination, a non-skip person has an interest in such property, or at no time after such termination may a distribution be made to a skip person, or a gift or estate tax is imposed on the trust property at the same time as the termination. I.R.C. § 2612(a); Treas. Reg. § 26.2612-1(b).

arises, therefore, to what extent, if any, G2b rather than G1 should be treated as the transferor of trust property passing to G3.

The first solution to the problem, called herein the "displacement" theory, is one that many observers feel intuitively must be correct. The theory holds that G2b fully displaces G1 as the transferor of any principal paid over to G3. Although the principal is held in a trust created by G1, G3 should be treated, according to the displacement theory, as receiving the principal from G2b. Consequently, in this view, no taxable termination occurs when trust property is paid over to G3, as G2b is the transferor of that property and G3 is not a skip person with respect to G2b. Put another way, the distribution of principal upon termination of the trust is treated as first paid over to G2b and then immediately transferred from G2b to G3. Thus, no generation-skipping transfer occurs.

The second solution is called herein the "portion theory." According to the portion theory, G2b should be treated as the transferor of a portion but not all of the underlying trust property. Specifically, G2b should be treated as the transferor of a portion (or fraction) of the trust equal to the value of G2b's gift divided by the value of the trust property at the time of the gift, while G1 should continue to be treated as the transferor of the balance of the trust property. Thus, according to the portion theory, G1 should be treated as the transferor of a portion of the property that is paid over to G3. Consequently, when the trust terminates, a taxable termination will occur with respect to G1's portion of the trust.

The third solution, called herein the "no effect" theory, is, perhaps, the least popular and most counterintuitive of the three. According to the no effect theory, although G2b is the donor of the remainder interest in the trust, G1 remains the transferor of the underlying trust property, both at the time of G2b's gift and when the trust terminates in favor of G3. In other words, G2b's assignment has no effect on the identity of the transferor of the underlying trust property, including any principal that the trustee pays over to G3. Consequently, a taxable termination occurs upon the termination of the trust in favor of G3.

This article examines the dueling transferors problem in detail. Part I of this article gives a brief overview of the GST tax and the central importance of the identity of the "transferor" of property for GST tax purposes. Part II introduces the dueling transferors problem through its application to one of the most popular gift and estate tax planning techniques: namely, grantor-retained annuity trusts or "GRATs." Part III demonstrates that the problem in fact has a much wider application than GRATs.

Part IV of this article examines the Service's policy-based critique of the "displacement theory" and argues that the critique has a wider application than commonly supposed. Part V exposes the technical flaws of the displacement theory. Part VI discusses the solution favored by the Service in private rulings, referred to herein as the "portion theory," and shows that the portion theory is, like the displacement theory, a defective solution to the dueling transferors problem.

Part VII of this article goes on to discuss the one binding authority to address the dueling transferors problem. Unfortunately, as will be seen, the authority, Treas. Reg. 26.2652-1(a)(5) Example 4, is not well drafted and is susceptible to different interpretations. Part VII nevertheless shows that the regulation is difficult to reconcile with either the displacement theory or the portion theory. Part VIII argues that the no effect theory follows from the definition of "transferor," is directly supported by Treas. Reg. 26.2652-1(a)(5) Example 4, and is indirectly supported by case law in the gift and estate tax area. Part IX applies the analysis of the GST tax consequences of gifts of beneficial interests to sales of beneficial interests for adequate consideration. Finally, part X of this article argues that the Service should publish a revenue ruling embracing the no effect theory.

Parts II and IV of this article focus, respectively, on GRATs and charitable lead annuity trusts or "CLATs." They essentially provide historical background as to how the Service and the commentators have analyzed the dueling transferors problem to date. Readers who are not interested in that history should feel free to skim or skip over parts II and IV.

I. Overview of the GST Tax and Centrality of the Transferor

The GST tax is designed to ensure that property is subject to wealth transfer tax at least once a generation.[5] Prior to the enactment of the GST tax in its current form,[6] taxpayers could potentially reduce their wealth transfer tax burden over time by creating trusts that would pass multiple generations before terminating. For example, a decedent might

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[5] A generation-skipping transfer tax was first enacted as part of the 1976 Tax Reform Act, Pub. L. No. 94-455, 90 Stat. 1520 (1976), although the need for some form of generation-skipping transfer tax had been recognized for many years before then. For an overview of the history of generation-skipping transfer taxation in the United States, including citations to primary and secondary sources, see Harrington et al., *supra* note 1, ¶ 1.02.

[6] The Tax Reform Act of 1986 repealed the generation-skipping transfer tax enacted by the 1976 Tax Reform Act and replaced it with the tax in its current form. In general, subject to exceptions, the tax applies to generation-skipping transfers made after September 25, 1985. Tax Reform Act of 1986, Pub L. No. 99-514 §§ 1433(a)-(d), 100 Stat. 2731-32 (1986), *amended by* Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647 § 1014(h)(2), 102 Stat. 3559-67 (1988); Treas. Reg. § 26.2601-1(a).

direct that his or her property be held in trust for descendants, including grandchildren and more remote descendants, for the maximum period permitted under the applicable rule against perpetuities. Although the property of the trust would be subject to estate tax at the decedent's death, it would not, prior to the enactment of the GST tax, be subject to any further wealth transfer tax until after the trust property was paid out to the beneficiaries and subsequently transferred by them. In this manner, a family's long-term wealth transfer tax burden could be minimized.

The GST tax addresses this perceived abuse by imposing a tax on generation-skipping transfers. The concept of "generation-skipping transfer" is expressed in a series of technical definitions and terms of art. Section 2611 of the Code[7] starts by defining a "generation-skipping transfer" as one of three types of events: a "direct skip," a "taxable termination" or a "taxable distribution." Each event involves a transfer to a "skip person." A direct skip is any transfer to a "skip person" that is subject to gift or estate tax.[8] A taxable termination is the termination of any interest in property held in trust (as defined in section 2652(c) of the Code), unless, (i) immediately after such termination, a non-skip person has an interest in the property, (ii) at no time after such termination may a distribution be made a skip person or (iii) a transfer of the property subject to gift or estate tax occurs at the same time as the termination.[9] Finally, a taxable distribution is any distribution from a trust to a skip person, other than a direct skip or a taxable termination.[10]

Both individuals and trusts may qualify as "skip persons." In the case of an individual, a "skip person" is someone who is two or more generations removed from the "transferor."[11] A trust is a "skip person" if all interests in the trust are held by skip persons[12] or, if no person has an interest in the trust, no distributions may be made to non-skip persons.[13] In both cases, the distance in generations to the "transferor" determines whether the trust or the individual qualifies as a skip person.

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7 References herein to the "Code" or "I.R.C." are to the Internal Revenue Code of 1986, as amended.

8 I.R.C. § 2612(c)(1); Treas. Reg. § 26.2612-1(c)(1).

9 I.R.C. § 2612(a)(1); Treas. Reg. § 26.2612-1(b).

10 I.R.C. § 2612(b); Treas. Reg. § 26.2612-1(c).

11 I.R.C. § 2613(a)(1); Treas. Reg. § 26.2612-1(d)(1).

12 "Interest in property held in trust" is a term of art for GST tax purposes. I.R.C. § 2652(c); Treas. Reg. § 26.2612-1(e)(1). An individual has an interest in property held in trust if he or she has a right to receive or is eligible or entitled to receive income or principal. I.R.C. § 2652(c)(1)(A)-(B); Treas. Reg. § 26.2612-1(e)(1)(i)-(ii). A charity has an interest in property held in trust if either it has a remainder interest in a charitable remainder trust or is entitled to receive income or principal. I.R.C. § 2652(c)(1)(A), (C); Treas. Reg. § 26.2612-1(e)(1)(i), (iii).

13 I.R.C. § 2613(a)(2); Treas. Reg. § 26.2612-1(d)(2).

The identity of the transferor, therefore, is crucial to determining whether a particular event is a generation-skipping transfer. If the transferor of property occupies a generation that is two or more generations higher than the recipients, then a generation-skipping transfer may occur upon a gift or bequest, a termination of an interest in property held in trust, or a distribution from a trust. By contrast, if the transferor of property occupies a generation that is no more than one generation higher than that of the recipients, then a generation-skipping transfer does not occur. Only after the transferor of property is identified, in short, does it become possible to determine whether GST tax may be imposed.

The Code defines the term "transferor" in section 2652(a)(1), as follows:

> Except as provided in this subsection or section 2653(a), the term "transferor" means—
> (A) In the case of any property subject to the tax imposed by chapter 11 [*i.e.*, estate tax], the decedent, and
> (B) in the case of any property subject to the tax imposed by chapter 12 [*i.e.*, gift tax], the donor.

In other words, subject to certain exceptions, the transferor is either the donor, in the case of property that was subject to gift tax, or the decedent, in the case of property subject to estate tax. Treasury regulations state simply that the transferor is "the individual with respect to whom property was most recently subject to Federal estate or gift tax."[14]

In most cases, the identity of the transferor is not in doubt. For example, a grandparent might make a completed gift to a trust for the sole benefit of a grandchild. As the funding of the trust is subject to gift tax, the grandparent becomes the transferor of that trust for GST tax purposes.[15] The gift to the trust would be a direct skip subject to GST tax.

The apparent simplicity of the definition of "transferor," however, belies its uncertain scope. Although some uncertainties have been resolved by regulation,[16] one profound uncertainty remains: namely, that

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[14] Treas. Reg. § 26.2652-1(a)(1). In determining whether a transfer was subject to gift or estate tax, exemptions, exclusions, deductions, and credits are not taken into account. Treas. Reg. § 26.2652(a)(2).

[15] Treas. Reg. § 26.2652-1(a)(5) (ex. 1). That a portion of the gift may have qualified for the gift tax annual exclusion under section 2503(b) of the Code does not affect the individual's status of the transferor of the trust. Treas. Reg. § 26.2652-1(a)(2).

[16] For example, Treas. Reg. § 26.2652-1(a)(5) Example 5 clarifies that, notwithstanding that "exemptions, exclusions, deductions, and credits" are disregarded for purposes of determining whether a transfer is subject to gift tax, the lapse of general power of appointment causes the power-holder to be the transferor of trust property only to the

it is unclear who should be treated as the "transferor" of underlying trust property after a beneficiary of a trust assigns his or her beneficial interest to another. In that case, the original settlor of the trust will meet the definition of "transferor," provided that (as will typically be the case) the initial funding of the trust was subject to gift or estate tax. The beneficiary's assignment, meanwhile, if made by gift, causes the beneficiary to be treated as the "transferor" of the beneficial interest. As will be seen, a consensus has yet to emerge as to which of the potential "transferors" should prevail over the other when trust property is paid over to (or the trust terminates in favor of) the substitute, donee beneficiary.

II. Dueling Transferors and GRATs

The problem of dueling transferors has been most often discussed in the context of grantor-retained annuity trusts or "GRATs."[17] GRATs have in recent years become one of the most popular – and well-publicized[18] – estate tax planning techniques. Perhaps because of their popularity, creative planners have looked for ways to use GRATs not only to pass wealth at reduced gift and estate tax cost but reduced GST tax cost as well. One technique that has been proposed is to have the remainder beneficiary of a GRAT assign his or her beneficial interest down a generation. As discussed in this section, the technique gives rise to a dueling transferors problem.

A. Overview of GRATs

A GRAT is a trust in which the grantor (or, after the death of the grantor, the grantor's estate) retains the right to the payment of an annuity for a term of years. If the remainder is payable to or for the benefit of members of the grantor's family within the meaning of section 2701(e)(2) of the Code, and the interest retained by the grantor is a "qualified interest" within the meaning of section 2702(b) of the Code, then the value of the taxable gift made by the grantor upon funding a GRAT is calculated by subtracting the value of the annuity (as deter-

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extent that the amount with respect to which the power lapses exceeds that greater of $5,000 or 5% of the value of the trust property.

17 David A. Handler & Steven J. Oshins*, The GRAT Remainder Sale,* 141 Tr. & Est., Dec. 2002 at 33, 36; David A. Handler & Steven J. Oshins, *GRAT Remainder Sale to a Dynasty Trust,* 138 Tr. & Est., Dec. 1999, at 20, 24 (1999); Steven J. Oshins & Arthur D. Sederbaum, *Generation-Skipping and the GRAT: Sale or Gift of the Remainder*, 30 Est. Plan. 259, 262 (June 2003); Harrington et al., *supra* note 1, ¶ 9.12(5)(a); Madoff et al., Practical Guide to Estate Planning § 9.04[G] (2001).

18 *See*, *e.g.*, Zachary R. Mider, *Accidental Tax Break Saves Wealthiest Americans $100 Billion*, Bloomberg (Dec. 17, 2013, 12:01 AM), http://www.bloomberg.com/news/articles/2013-12-17/accidental-tax-break-saves-wealthiest-americans-100-billion.

mined using the discount rate in effect under section 7520 of the Code)[19] from the total value of the property transferred.[20] To the extent that the GRAT property earns returns greater than necessary to pay the annuity amounts to the grantor, wealth above the amount of any taxable gift made by the grantor when the GRAT was created passes to the remainder beneficiaries free of additional gift or estate tax, provided that the grantor survives the fixed term.[21]

GRATs combine several advantages. First, it seems that a GRAT can be created without the grantor making any more than a *de minimis* taxable gift.[22] Second, even if property transferred to a GRAT turns out to have been undervalued, the risk is slight that the grantor will be treated as having made a substantially increased taxable gift.[23] Third, a GRAT allows the grantor, through the retained annuity payments, to retain access to the property transferred to the GRAT.[24] Fourth, there

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[19] I.R.C. § 2702(a)(2)(b).

[20] *See* Treas. Reg. §§ 25.2511-1(e), 25.2702-3(b). If the remainder is not payable to or for the benefit of members of the grantor's family, then the value of the taxable gift is calculated in the same fashion (*i.e.*, by subtracting the value of the grantor's retained interest from the total value of the transferred property), even if the grantor's retained interest is not a qualified interest, so long as the grantor's retained interest is susceptible of measurement. Treas. Reg. § 25.2511-1(e).

[21] If the grantor does not survive the fixed term, all or a portion of the underlying trust property will be included in the grantor's gross estate under section 2036(a)(1) of the Code, which is the same result that would have obtained had the grantor not created the GRAT. Treas. Reg. § 20.2036-1(c).

[22] If the annuity is payable to the grantor or the grantor's estate, it becomes mathematically possible to reduce the value of the taxable gift to zero or nearly to zero. This technique is approved in Treas. Reg. § 25.2702-3(e) (ex. 5-6); *see also* Walton v. Comm'r, 115 T.C. 589, 597, 600 (2000), *acq.* I.R.S. Notice 2003-72, 2003-44 I.R.B. 964. It is unclear whether the Internal Revenue Service (the "I.R.S.") will respect a GRAT whose remainder has for gift tax purposes a value of zero. *See*, *e.g.*, T.A.M. 200245053 ("[The regulations] should not be viewed as sanctioning the utilization of the formula to 'zero-out' a gift"); *but see* Austin W. Bramwell, *Considerations and Consequences of Disclosing Non-Gift Transactions*, 116 J. TAX'N 19, 29, 32 (2012) (arguing that that the Internal Revenue Service is statutorily bound to accept the validity of zeroed-out GRATs).

[23] Treas. Reg. § 25.2702-3(b)(2) allows the grantor's retained annuity interest to be stated in terms of a "percentage of the initial fair market value of the trust property," provided that the governing instrument contains certain provisions, including that the trust shall pay to the grantor "within a reasonable period after the final determination of such value" the difference between the amount actually paid to the grantor and the amount which should have been paid, if the initial value has not been understated. Treas. Reg. § 1.664-2(a)(1)(iii). In other words, if the property transferred to a GRAT turns out to have been undervalued, the GRAT may be structured so that the grantor's annuity payments will be automatically increased so as to absorb nearly all of the increase in the size of the gift.

[24] Despite the gift and estate tax advantages of making lifetime gifts, taxpayers are often reluctant to part with wealth during their lifetimes. With a "zeroed out" GRAT (*i.e.*, one that is structured so the value of the remainder is zero), however, the grantor

is no tax downside if a GRAT fails to generate a remainder that passes free of gift and estate tax to the next generation, other than the (typically, very small) taxable gift made when the trust was created.[25]

Finally, GRATs can pass on wealth to the next generation even if the grantor does not know or cannot predict which of his or her assets will earn the highest returns. If the grantor has a portfolio of different assets, then, in any given short-term period, at least some of those assets may earn returns in excess of the interest rate determined under section 7520 of the Code (the "*section 7520 rate*"), which is the discount rate used to value the grantor's retained annuity interest for gift tax purposes. Over successive short-term periods, the probability that at least some assets will outperform the section 7520 rate in at least one such period approaches one.[26] Thus, if a taxpayer creates multiple short-term GRATs, each funded with a highly concentrated position, and pays over into new short-term GRATs the annuity payments received from his or her existing GRATs, then the GRATs as a whole will almost certainly pass on wealth to the next generation free of gift and estate tax, so long as the grantor survives the fixed terms. Given the virtual certainty of success, it is no wonder that both President Obama[27] and members of prior Congresses,[28] have proposed reforms that purport to curtail the effectiveness of GRATs.

B. Using GRATs to Pass Wealth to Skip Persons Through an Assignment of the Remainder Interest

Creative planners, aware of the opportunities for tax-efficient wealth transfers to be achieved via GRATs, have proposed a variety of ways to make the same opportunities available in the GST tax context.

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only gives away returns above the section 7520 rate. Even if those returns may be substantial, some taxpayers find it psychologically easier to part with future returns than with realized wealth.

25 If property gifted to a GRAT fails to earn returns in excess of the section 7520 rate, then the property simply returns to the grantor in the form of annuity payments. If the grantor dies during the fixed term, then the property is paid over to his or her estate and all or a portion of it will be included in his or her gross estate. *See* Treas. Reg. § 20.2036-1(c)(2).

26 As discussed in Jonathan G. Blattmachr et al., Partial Interests – GRATs, GRUTs, QPRTs (Section 2702), No. 836-2nd, at A-99, the proposition that a program of "rolling" GRATs always succeeds in the long run in passing on wealth to the next generation free of gift and estate tax (so long as the grantor survives) can be demonstrated using Monte Carlo simulations.

27 U.S. Treasury, General Explanations of the Administration's. Fiscal Year 2015 Revenue Proposals, 162-63 (Mar. 2014), *available at* http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2015.pdf.

28 *See*, *e.g.*, The Small Business & Infrastructure Jobs Tax Act of 2010, H.R. 4849, 111th Cong. § 307 (2010).

One proposal[29] has been to have the remainderman of a GRAT, who would not be a skip person with respect to the grantor, assign his or her remainder interest down to the next generation, either by a gift or by sale. Proponents of the strategy argue that the assignment causes a change of transferors of trust property and, therefore, should permit GRAT property to pass down multiple generations free of GST tax.

The assignment-of-the-remainder-interest strategy has several variations. In its simplest form, it would work as follows:

> Example 2: G1 funds a GRAT with $1 million and retains the right to receive an annuity for a period of two years. Upon the expiration of the fixed term, any remaining property (after payment of the final annuity amount to G1) is directed to be paid over to G2 (or G2's estate). The present value of the annuity at the time that the GRAT is funded is $999,000, so that G1 makes a taxable gift of $1,000 when the GRAT is created. Shortly after the GRAT is created, G2 irrevocably assigns his remainder interest to G3. The assignment is effective under local law and for gift tax purposes. As a result of returns earned by the GRAT that exceed the section 7520 rate, the remaining property of the GRAT, after the fixed term ends and the final annuity is paid to G1, is $100,000.

Here, G2 makes a taxable gift to G3 that is equal to the value of the remainder interest at the time of the assignment. As the gift is made soon after the creation of the GRAT, and before there has been appreciation of the GRAT property, the value of G2's gift, like the value of G1's gift, is only $1,000.

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[29] There have been other proposals for GST tax planning with GRATs, discussion of which is beyond the scope of this article. For example, some have explored whether a grantor of a GRAT could name skip persons as the remainder beneficiaries of a GRAT and take the position that a small direct skip, subject only to a *de minimis* assessment of GST tax, occurs on creation. A closely related suggestion is to attempt to allocate GST exemption as of inception of the GRAT, as permitted in many cases by Treas. Reg. § 26.2632-1(c)(2)(ii)(A). It appears that neither of these strategies will work. For an examination of these strategies' flaws, *see* Austin W. Bramwell, *Generation-Skipping Transfer Tax Consequences of GRATs: Finding the Answers,* 114 J. TAX'N 260, 264 (2011). A more promising strategy is for skip persons to acquire a remainder interest in a GRAT through a split purchase annuity trust. *See* BLATTMACHR ET AL., *supra* note 26, at A-71 to 75; *see also* N. Todd Angkatavanich & Karen E. Yates, *The Preferred Partnership GRAT – A Way Around the ETIP Issue?,* 35 ACTEC L. J. 289, 289, 292-94 (2009) (observing that GST tax leverage can be achieved through a gift in trust of the common interests in a preferred partnership that complies with the requirements of section 2701 of the Code, and that additional gift tax leverage can be achieved by transferring the preferred interests to a GRAT).

Proponents of the assignment-of-a-remainder strategy argue that G2 should be treated as the transferor for GST tax purposes of any property that, at the end of the fixed term, is paid over to G3. Consequently, according to this view, returns on the GRAT property in excess of the amounts required to pay the annuity to G1 should pass free of GST tax to G3, notwithstanding that G3 is a skip person with respect to G1. In short, G2 would have successfully transferred $100,000 of property to G3 free of GST tax at a gift tax cost of only $1000, even though G3 is a skip person with respect to G1, the creator of the GRAT.

The crucial assumption in the foregoing analysis is that G2 should, in fact, be treated as the transferor of any property passing from the GRAT to G3. To put the point more precisely, GST tax is avoided in Example 2 only if G2 is treated as the transferor of *both* (i) the remainder *interest* in the GRAT property and (ii) the GRAT property itself. The first assumption is not controversial: G2 makes a taxable gift of a remainder interest in the GRAT; consequently, under the general definition of "transferor," G2, as the individual with respect to whom the remainder interest was most recently subject to estate or gift tax, is the transferor of the remainder interest.[30] Thus, had G2 assigned the remainder interest to his or her own grandchildren (G4s), the assignment would have been a direct skip subject to GST tax.

But the second assumption – that G2 becomes the transferor of the underlying GRAT property – is problematic. In Example 2, G1 funded the GRAT and, therefore is, at least initially, the transferor of the GRAT.[31] For G2 to become the transferor of property paid over from the trustee to G3, G2 must at some point *displace* G1 as the transferor of the underlying GRAT property. If the displacement fails to occur and G1 remains the transferor of the GRAT property, then, despite G2's gift of the remainder interest in that property, a taxable termination would occur upon expiration of the fixed term. As will be seen, whether and when a gift of a beneficial interest causes the original transferor to be displaced are both unclear. A gift of a remainder interest in a GRAT, in short, gives rise to a dueling transferors problem.

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30 *See* Treas. Reg. § 26.2652-1(a)(1).

31 *See id.; see generally* Bramwell, *supra* note 29, at 262. Although G1 only makes a taxable gift equal in value to the remainder interest, G1 is the transferor of all of the GRAT property. *Cf.* Treas. Reg. § 26.2652-1(a)(5) (ex. 9) (explaining that a spouse who consents to split gifts for the year is treated as the transferor of one-half of the property transferred to the GRAT, even though the taxable gift of the remainder interest was significantly less).

III. DUELING TRANSFERORS WITHOUT GRATS

The possibility of avoiding GST tax through gifts of remainder interests in GRATs has inspired an extensive literature.[32] Yet GRATs represent just one of many different forms of trust. The variety of trusts, the beneficial interests in which can be assigned, is limited only by the imagination of grantors and a handful of "mandatory" rules of trust law.[33] Despite the narrow focus of the literature to date on GRATs, the dueling transferors problem can in fact arise in a virtually unlimited number of different circumstances, including but not limited to assignments of remainder interests in GRATs.

Moreover, a narrow focus on GRATs can lead commentators to underestimate the significance of the dueling transferors problem. If, as some have argued, an assignment of a beneficial interest in a trust should cause a change of transferors, then the planning opportunities that would be available using trusts *other* than GRATs would potentially dwarf those that would be available using GRATs. The following is an example:

> <u>Example 3</u>: A trust is created under G1's will for the benefit of G1a and G2b. The trust provides that all income is to be paid to G2a for G2a's life. The trustee also has absolute discretion to pay over principal to G2b. G2a assigns the income interest to G3 for no consideration. The assignment is effective under local law.

In this example, the income interest in the trust can be curtailed or defeated to the extent that principal is distributed to G2b. That is, if the trustee exercises its discretion to distribute some or all of the trust principal to G2b, then the income interest in the distributed property would effectively be terminated.

In the language of Treasury regulations, the income interest is a "restricted beneficial interest"[34] that cannot be valued using standard actuarial factors.[35] Rather, as the Service has held, the value of an interest that is subject to curtailment or elimination through the exercise of a discretionary power can be discounted, perhaps significantly. In Rev.

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[32] For more on this technique, see Handler & Oshins, *The GRAT Remainder Sale*, *supra* note 17, at 33-34; Handler & Oshins, *GRAT Remainder Sale to a Dynasty Trust*, *supra* note 17, at 20, 21, 24 (1999); Oshins & Sederbaum, *supra* note 17, at 262-63; HARRINGTON ET AL., *supra* note 1, ¶ 9.12(5); MADOFF ET AL., *supra* note 17, § 9.04[G].

[33] A leading treatise states in the introduction that "[t]he purposes for which we can create trusts are as unlimited as our imagination." AUSTIN W. SCOTT ET AL., SCOTT AND ASCHER ON TRUSTS § 1.1 (5th ed. 2007); *see also* John H. Langbein, *Mandatory Rules in the Law of Trusts,* 98 NW. U. L. REV. 1105 (2004).

[34] Treas. Reg. § 25.7520-3(b)(1)(ii).

[35] Treas. Reg. § 25.7520-3(b)(1)(ii); *see also* Treas. Reg. § 25.7520-3(b)(2)(v) (ex. 3).

Rul. 67-370, for example, the decedent (or the decedent's estate) was to receive the remainder of an inter vivos trust upon the death of the settlor. The settlor, however, had reserved at the time of the decedent's death the right to revoke or amend the trust. The Service ruled that the decedent's remainder interest was includible in the decedent's estate under section 2033 of the Code.[36]

In that same ruling, the Service recognized that the value of the interest included in the decedent's gross estate was "affected by its possible curtailment or complete divestment at some point after decedent's death." In other words, a property interest that is subject to a third party's discretionary power to divest or curtail the interest is worth less (perhaps, significantly less) than a property interest that is not so subject.[37] The Service has since reiterated in both public rulings[38] and numerous non-precedential private rulings[39] that the determination of an interest's value should reflect any possibility that that it could be defeated through the exercise of another's discretion.[40]

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36 This conclusion, although outside the scope of this article, has been criticized. *See* Mitchell M. Gans, et al., *Estate Tax Exemption Portability: What Should the IRS Do? And What Should Planners Do in the Interim?,* 42 REAL PROP., PROB. & TR. J. 413, 427 n.44 (2007).

37 Rev. Rul. 67-370*. Cf.* Snyder v. Comm'r*,* T.C. Memo. 1989-529. (holding that the value of a gift of common stock prior to the enactment of chapter 14 of the Code could be discounted in order to reflect the rights of preferred shareholders' put rights).

38 *See* Rev. Rul. 75-550 (valuing an income interest at a discount to reflect all possible invasions of principal).

39 *See, e.g.,* PLR 8535020 (May 30, 1985) ("The fact that the trustee has discretion regarding distributions of income and principal to you is a factor that must be taken into account in determining the fair market value of your beneficial interest"). *See also* PLR 8824025 (June 17, 1988) (the value of discretionary interest in principal appears "negligible" where no distributions had been made); PLR 8905035 (Nov. 4, 1988) (the value of a discretionary interest is to be valued under general valuation principles); PLR 9451049 (Sept. 22, 1994) (the value of the right to distributions for support "is readily ascertainable"); PLR 9714030 (Jan. 7, 1997) (the value of discretionary interest is to be valued under general valuation principles); PLR 9802031 (Oct. 14, 1997) (the value of discretionary support interest "is determined based on all relevant factors, such as the projected needs of [the beneficiary] for health, education, support, and maintenance for the remainder of his life"); PLR 9811044 (Dec. 11, 1997) (the value of discretionary interest is to be valued under general valuation principles); PLR199908060 (Dec. 2, 1998) (discretionary interests "have some value, however minimal"); PLR 200243026 (July 24, 2002) (the value of interest subject to discretion of trustee is a question of fact); PLR 200339021 (June 19, 2003) (the value of a contingent support interest is a question of fact); PLR 200745015 (June 6, 2007) (a discretionary interest has "more than a nominal value"); PLR 200745016 (June 8, 2007) (a discretionary interest has "more than a nominal value"); PLR 201122007 (Feb. 24, 2011) (a discretionary interest where no distributions received may be "merely nominal"); PLR 201342001 (July 22, 2013) (expressing no opinion on the value of discretionary interests).

40 In *Robinette v. Helvering*, 318 U.S. 184, 188-89 (1943), the court held that the value of a taxpayer's gift was not reduced by a retained reversion whose value was impos-

The principle that the value of a restricted beneficial interest should be reduced to reflect the possibility of curtailment or divestment, when combined with the theory – referred to in this article as the "displacement theory" – that an assignment of a beneficial interest causes a change in the identity of the transferor of underlying trust property, creates potentially explosive GST tax planning opportunities. In Example 3 above, for example, the value of G2a's gift of an income interest to G3 could likely be discounted to reflect the trustee's absolute discretion to defeat the income interest altogether by distributing principal to G2b. Yet if G2a becomes the transferor for GST tax purposes of any distributions to G3, all of the income from the trust will pass free of GST tax down a generation to G3, so long as the trustee simply fails to distribute principal to G2b. In other words, at a relatively small gift tax cost to G2a, G1's family could, with the cooperation of the trustee, cause all of the income of the trust to pass free of GST tax.[41]

Perhaps an even more striking example of the GST tax planning opportunities that arise under the displacement theory is as follows:

> <u>Example 4</u>: G1 creates a trust under G1's will that permits income or principal to be paid over to G2a during G2a's life in the absolute discretion of the trustee. Upon G2a's death, the remainder is to be paid over to G2b or G2b's estate. G2b makes a gift of the remainder interest to G3. The assignment is effective under local law.

In Example 4, the remainder beneficiary has no assurance that any principal or accumulated income will be available to be paid over at all upon

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sible to determine. *Robinette*'s holding that the value of a retained interest, if not susceptible of measurement, is ignored for gift tax purposes was later embodied in gift tax regulations. *See* Treas. Reg. § 25.2511-1(e). The holding could, perhaps, have been extended to deny any valuation discount where the amount of the discount is difficult to determine. The courts, however, have not so extended *Robinette*. On the contrary, it is well-established that valuation discounts are permitted, notwithstanding difficulties in determining the extent of the discount. *See*, *e.g.,* Galt v. Comm'r*,* 216 F.2d 41, 50 (7th Cir. 1954) (upholding taxpayer's valuation of a gift despite that "the value of the gift . . . was speculative, uncertain and contingent upon future developments").

41 A recent article has, on very similar facts, including that the trustee had absolute discretion to invade principal, concluded that the initial transferor of a trust (in Example 3, G1) "probably would not" remain the transferor of income distributed to a substitute income beneficiary following an assignment of the income interest by the initial income beneficiary. Jonathan G. Blattmachr et. al., *Portability or No: The Death of the Credit Shelter Trust?,* 118 J. TAX'N 232, 246 (2013). The authors focus on the case of a trust that happens to have a zero inclusion ratio (and therefore is effectively exempt from GST tax) in virtue of allocation of GST exemption by the original transferor. *Id.* at 246. Presumably, the authors would reach the same conclusion in the case of a trust that has an inclusion ratio of greater than zero. For a more skeptical analysis, see HARRINGTON ET AL., *supra* note 1, ¶ 9.12(5).

G2a's death, as the trustee has absolute discretion to pay over all of the property of the trust to G2a during G2a's life. Thus, it seems that the value of G2b's gift of the remainder interest is very small. Yet if G2b is treated as the transferor of any property that is paid over to G3, the entire property of the trust, including all accumulated income, can pass free of GST tax, so long as the trustee chooses not to distribute any income or principal to G2a. At *de minimis* gift tax cost, in other words, the family would be able to pass property down multiple generations free of GST tax.

As will be seen in part V of this article, the displacement theory appears to be based on a misunderstanding of the Code's definition of "transferor." As an initial matter, however, the opportunities that would be available under the displacement theory should give planners pause. It is unlikely that Congress, in imposing a tax on generation-skipping transfers, intended the tax to be so easily escaped.[42]

IV. The Service's Policy-Based Critique of the Displacement Theory

Not surprisingly, given the potential for abuse, the Service has not embraced the displacement theory.[43] The Service's most forceful cri-

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[42] Suppose that, contrary to the position advanced in this article, the displacement theory is true. What resources would the Service have to shut down the potential for abuse? A full answer to the question is outside the scope of this article. In any event, none of the possible avenues for attack appears very promising. The Service could, for example, attempt to resurrect the "open transaction" doctrine, which historically caused gifts to be considered incomplete until they were capable of being valued. As the doctrine's leading exponent has recently acknowledged, however, it has been "discredited." Gans et al., *supra* note 36 at 441-42. *Cf.* Mitchell M. Gans, *Gift Tax: Valuation Difficulties and Gift Completion,* 58 Notre Dame L. Rev. 493, 515 (1983). Further, even when the doctrine was viable, the Service never applied it to gifts of restricted beneficial interests. Other arguments that the Service might attempt are (i) the value of a restricted beneficial interest should not be discounted after all; (ii) an assignment of a restricted beneficial interest is not actually a taxable gift that causes a change of transferors, as the gift tax is not imposed on assignments of "mere expectancies"; (iii) an assignment of a restricted beneficial interest is ineffective for state law purposes and therefore is not a completed gift for federal gift tax purposes; and (iv) other beneficiaries will have made indirect taxable gifts by acquiescing in the exercise of discretion in a way that maximizes GST tax leveraging.

[43] In a series of PLRs, however, the Service may have inadvertently accepted the theory, which, as discussed in detail *infra* note 180 and in part IX.H of this article, is closely related to the displacement theory, that a sale of a beneficial interest for full and adequate consideration to another trust causes the transferor of the purchasing trust to become the transferor of any property that is later paid over to the purchasing trust. *See* PLR 200442019 (Apr. 21, 2004); *see also* PLR 200442020 (Apr. 21, 2004); PLR 200443023 (Apr. 21, 2004); PLR 201026014 (Feb. 24, 2010); PLR 201026024 (Feb. 24, 2010); PLR 201026025 (Feb. 24, 2010); PLR 201026026 (Feb. 24, 2010); PLR 201026027 (Feb. 24,

tique of the theory is found in a private letter ruling, PLR 200107015, involving a gift of a remainder interest in a charitable lead annuity trust or "CLAT."[44] CLATs, as discussed below, have their own unique GST tax rules. As a result, the ruling leaves it unclear, at least at first, to what extent the Service would reject the displacement theory outside the CLAT context. The Service's position should nevertheless, as discussed below, be understood to apply well beyond the CLAT context.

A. CLATs: An Overview

A charitable lead annuity trust or "CLAT," such as the one featured in PLR 200107015, is an irrevocable trust that provides for a sum certain to be paid to charity at least annually for a term of years or for the lives of one or more individuals.[45] Upon the end of the fixed term, the remainder is directed to be paid over to (or held for the benefit of) noncharitable beneficiaries, such as the grantor's descendants. The lead annuity interest in a CLAT, if properly structured, qualifies for the gift tax charitable deduction (in the case of a CLAT created during lifetime) or the estate tax charitable deduction (in the case of a CLAT created at death).[46] Consequently, the value of the property that is subject to gift or estate tax is limited to the value of the remainder interest as of the creation of the CLAT.

The value of the remainder interest is determined as of the date of the donor's gift, in the case of a CLAT created during lifetime, or as of the decedent's death, in the case of a CLAT created at death, based in part on a present value discount rate equal to the section 7520 rate.[47] The annual (or more frequent) sums required to be paid to charity from a CLAT can be defined, using the section 7520 rate, so that the present value of the charitable annuity interest is equal or nearly equal to the entire value of the property transferred to the CLAT. If the CLAT is "zeroed out" in this manner, then the size of the taxable gift (in the case of a CLAT created during lifetime) or the amount included in the dece-

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2010); PLR 201136011 (June 7, 2011); PLR 201136012 (June 7, 2011); PLR 201136013 (June 7, 2011); PLR 201136014 (June 7, 2011); PLR 201136015 (June 7, 2011).

44 PLR 200107015 (Nov. 14, 2000).

45 The measuring lives may not include persons others than the donor, the donor's spouse, the decedent's spouse (if the CLAT is created inter vivos), and ancestors of the remainder beneficiaries or a spouse of a lineal ancestor. Treas. Reg. § 20.2055-2(e)(2)(vi); Treas. Reg. § 25.2522(c)(vi)(a). For an overview of the requirements of CLATs, *see* Rev. Proc. 2007-45, 2007-2 C.B. 89; *see also* Rev. Proc. 2007-46, 2007-2 C.B. 102; Rev. Proc. 2008-45, 2008-30 I.R.B. 224; Rev. Proc. 2008-46, 2008-30 I.R.B. 238.

46 *See* I.R.C. § 2055(e)(2)(B); *see also* I.R.C. § 2522(c)(2)(B).

47 Treas. Reg. 20.2031-7(d)(2)(iv); Treas. Reg. § 20.2055-2(f)(2)(iv); Treas. Reg. 25.2512-5(d)(2)(iv); Treas. Reg. 25.2522(c)-3(d)(2)(iv).

dent's taxable estate (in the case of a CLAT created at death) will be *de minimis*.

Meanwhile, to the extent a zeroed-out CLAT earns returns greater than necessary to pay the annuity amounts to charity, wealth can pass to the remainder beneficiaries free of additional gift or estate tax. If, on the other hand, the CLAT earns returns that are less than the section 7520 rate, then the CLAT may be unable to fund all of the annuity amounts required under the terms of the trust, and the remainder beneficiaries are no worse off. In essence, with a zeroed-out CLAT, the benefit of any "upside" returns in excess of the section 7520 rate pass free of gift or estate tax to descendants, while the risk that returns will be less than the section 7520 rate is borne by charity.

B. CLATs and GST Tax

As noted, CLATs are subject to unique GST tax rules. Those rules pertain to the allocation of what is known as the settlor's "GST exemption." In general, under section 2631 of the Code, every individual is allowed a GST exemption amount (in 2015, $5,430,000),[48] which may be allocated to any property of which such individual is the transferor. An allocation of GST exemption increases what the Code defines as the "applicable fraction," which in turn, via other definitions of the Code,[49] effectively reduces the rate of GST tax, often to as little as zero percent. The allocation of GST exemption, in other words, can cause a trust to become effectively exempt from GST tax.

In most cases, the applicable fraction of a trust is the amount of GST exemption allocated to the trust, divided by a denominator equal to the value of the property transferred.[50] For example, if a taxpayer allocates $1 million of GST exemption to a trust, and the value of the property transferred to the trust is also $1 million, then the applicable fraction is $1 million divided by $1 million, or 1. The consequence of having an applicable fraction of 1 is that the effective GST tax rate imposed on the trust will be zero percent.

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48 Rev. Proc. 2014-61, 2014-47 I.R.B. 860.

49 The applicable fraction reduces what is known as the "inclusion ratio," which is defined to be equal to one minus the applicable fraction. I.R.C. § 2642(a)(1). The inclusion ratio is then multiplied against the maximum federal estate tax rate in order to produce the applicable rate of GST tax. I.R.C. § 2641(a). Thus, an applicable fraction of one produces an inclusion ratio of one minus one, or zero. Zero multiplied by the maximum federal estate tax rate is zero, so the GST tax rate in that case would effectively be zero.

50 I.R.C. §§ 2642(a)(2)(A)-(B)(i). The value of the property transferred is often, but not always (such as if a late allocation of GST exemption is made), determined as of the date of transfer. I.R.C. § 2642(b)(1)(A)-(B).

In addition, where a transfer to a trust qualifies in part for the gift or estate tax charitable deduction, the denominator of the applicable fraction is normally reduced by the amount of the deduction allowed.[51] Suppose, for example, that $1 million is transferred in a decedent's will to a charitable lead *unitrust*. The trust directs that 10% of the trust property be paid over to charity for a period of twenty-five years. At the end of the fixed term, any remaining property is paid over to the decedent's grandchild. Suppose further that the value of the remainder is equal to 30% of the entire property, or $300,000, while the value of the charitable unitrust interest is equal to the balance, or $700,000. The decedent's executors in that case would not need to allocate $1 million of GST exemption in order to cause the trust to have an applicable fraction of 1. On the contrary, the denominator of the applicable fraction will be $1 million, reduced by the $700,000 charitable deduction. Thus, to produce an applicable fraction of 1, only $300,000 of GST exemption would need to be allocated.

The rule that the denominator of the applicable fraction is reduced by the value of charitable deduction property would, but for a special rule discussed below, create a planning opportunity in the case of CLATs. As discussed, to the extent a CLAT earns returns in excess of the section 7520 rate, those returns pass free of gift or estate tax. The Code's definition of applicable fraction would likewise permit those same returns to pass free of GST tax, provided that GST exemption equal to the value of the remainder is allocated to the CLAT. As the legislative history to the Technical and Miscellaneous Revenue Act of 1988 explains:

> The effect of deducting the present value of any charitable lead annuity interest from the denominator of the applicable fraction is to permit leveraging of the exemption amount. Thus, if the trust assets sufficiently outperform the rate of return assumed in computing the present value of the charitable interest, the amount passed to noncharitable persons can exceed the amount which would have been passed to them had there been no charitable interest in the trust.[52]

In many cases, such as with a nearly zeroed out CLAT, the amount of GST exemption required to make a CLAT effectively exempt from GST tax would, under the general definition of the applicable fraction, be *de minimis*.

Not long after the GST tax was enacted in its current form, however, Congress decided that taxpayers should not be able to make

51 I.R.C. § 2642(a)(2)(B)(ii)(II).
52 S. Rep. No. 100-445, at 368 (1988).

CLATs effectively exempt from GST tax through the allocation of small amounts of GST exemption as of inception. Congress's solution was the enactment of section 2642(e) of the Code. That section now provides that the denominator of a CLAT's applicable fraction is equal to value of the trust property immediately after termination.[53] Thus, if the CLAT earns returns in excess of the section 7520 rate, the denominator of the application fraction will increase, and, with it, the effective GST tax rate (unless additional GST exemption is allocated).[54] As a result of this rule, taxpayers cannot, by allocating GST exemption as of creation of the CLAT, shield returns on CLAT property in excess of the section 7520 rate from GST tax.

C. The Service's Rejection of the Displacement Theory

In PLR 200107015,[55] the taxpayers proposed a strategy that, if upheld, would permit CLAT remainders to pass to skip persons free of GST tax without technically running afoul of section 2642(e) of the Code. In the ruling, a decedent had created a CLAT under his will. The trust directed that a fixed amount be paid annually to a charity for a period of twenty-five years. After the twenty-five-year fixed term, the trustee was directed to hold the remaining trust property in further trust for the decedent's descendants and charities.

The trustee was given a broad power under the decedent's will to amend the dispositive provisions of the CLAT, so long as only the decedent's descendants and charities were the beneficiaries of any amendment. In the ruling, the trustee proposed to use this power to give a child of the decedent a vested interest in one-sixth of the remaining principal at the end of the fixed term. The child then proposed to make a gift of the one-sixth remainder interest to his own children, the decedent's grandchildren.

The taxpayers who sought the ruling argued that, following the gift, the decedent's child, as the donor of a one-sixth remainder interest in the CLAT, should be treated as the transferor of any property paid over to the child's own children at the end of the fixed term. In other words, the taxpayers advocated the displacement theory: In their view, the gift of a remainder interest caused the child to fully displace the decedent as the transferor of the CLAT property passing to the grandchildren. Although the grandchildren were skip persons with respect to the decedent, they were not skip persons with respect to the decedent's child, the

53 I.R.C. § 2642(e)(1)(B).

54 The amount of GST exemption allocated to a CLAT is increased by an amount of interest at the section 7520 rate used for estate or gift tax charitable deduction purposes for the period of the charitable annuity. I.R.C. § 2642(e)(2); Treas. Reg. § 26.2642-3(b).

55 PLR 200107015 (Nov. 14, 2000).

donor of the remainder interest. Consequently, under the displacement theory, no GST tax would be due at the end of the fixed term.

The Service did not agree. According to the Service, the transaction proposed by the taxpayers, if successful, would violate the policies underlying the rule of section 2642(e) of the Code. As the Service put it:

> The series of transactions proposed in the ruling request have the effect of circumventing the rules of section 2642(e) using the same type of leveraging that prompted Congress to enact section 2642(e). The trustees propose to designate Child A as the beneficiary of one-sixth of the remainder interest in Trust. Child A will then assign Child A's one-sixth remainder interest to Child A's children in a transaction that is subject to gift tax.

In other words, a gift of a remainder interest in a CLAT was, in effect, an attempt to avoid the rule of section 2642(e) of the Code. Instead of the grantor of the CLAT allocating a *de minimis* amount of GST exemption – a strategy prohibited under section 2642(e) of the Code – a non-skip person remainderman proposed to make a *de minimis* gift of the remainder interest down a generation. If the strategy worked, CLAT property, including returns could pass multiple generations free of GST tax.

The Service correctly saw that the taxpayer's strategy was premised on the displacement theory: that is, the taxpayers assumed that a gift of a remainder interest in a CLAT makes the donor of the interest the transferor of 100% of the property passing to the substitute, donee beneficiary. To prevent that result, the Service instead proposed the portion theory: that is, that the donor of the remainder interest should be the transferor of a portion of the CLAT equal to the value of the remainder interest at the time of the donor's gift divided by the value of the property of the CLAT. As the value of the remainder interest at the time of the child's gift appears to have been small compared to the value of all of the property of the CLAT, the donor of the remainder interest would be treated as the transferor of only a small fraction of the underlying trust property. Contrary to the taxpayer's proposed analysis, therefore, most of the property ultimately passing to the donees of the remainder interest, *i.e.*, the decedent's grandchildren, would, according the Service's analysis, be subject to GST tax.[56]

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[56] The Service's theory, which this article refers to as the "portion theory," is discussed *infra* in part VI of this article.

D. PLR 200107015 and Gifts of Remainder Interests in GRATs

In rejecting the displacement theory, the Service in PLR 200107015 understandably relied heavily on the policies behind section 2642(e) of the Code. The Service's reliance on that section, however, creates an apparent vulnerability: namely, that section 2642(e) of the Code is narrowly focused on CLATs. Outside of the CLAT context, the section does not apply. It is unclear, therefore, whether the Service could invoke the same policy concerns where individuals assign interests in trusts other than CLATs.

For example, some have argued that the reasoning of PLR 200107015 should not have any bearing on GRATs. In response, some have noted that many GRATs are subject to another rule governing allocation of GST exemption, known as the "estate tax inclusion period" or "ETIP" rule of section 2642(f) of the Code.[57] Generally, under the ETIP rule, taxpayers may not allocate GST exemption to a trust if, immediately after the transfer, the trust property could be included in the gross estate of either the grantor or the grantor's spouse. As all or a portion of a GRAT will, in fact, be included in the grantor's gross estate under section 2036(a)(1) of the Code if he or she dies during the fixed term, it might seem at first that GRATs are always subject to the ETIP rule. Thus, some have suggested, the ETIP rule, just like the rule of section 2642(e) of the Code in the case of CLATs, furnishes grounds for the Service to reject the displacement theory in the case of GRATs.

On closer inspection, however, it turns out that the ETIP rule is not a reason to reject the displacement theory. For one thing, the rule actually fails to prevent allocation of GST exemption to many GRATs as of the date of creation. Under Treas. Reg. § 26.2632-1(c)(2)(ii)(A), GST exemption may be allocated to property as of the date of an initial gift, so long as there is less than a 5% probability that the property will be included in the grantor's gross estate for estate tax purposes. In the case of many GRATs, the 5% probability requirement is easy to satisfy. Although all or a portion of a GRAT will be included in the grantor's gross estate under 2036(a)(1) of the Code if the grantor dies during the fixed term, the probability of the grantor actually dying during the fixed term

[57] The ETIP rule is popularly but erroneously blamed as an obstacle to GST tax planning with GRATs. In fact, if anything, the ETIP rule is the taxpayer's friend, as it prevents many inefficient allocations of GST exemption. A full discussion of the ETIP rule is beyond the scope of this article. Readers wishing to understand how the ETIP rule affects planning with GRATs are referred to Austin W. Bramwell, *Generation-Skipping Transfer Tax Consequences of GRATs: Finding the Answers,* 114 J. TAX'N 260 (2011).

is often very low. According to I.R.S. actuarial tables,[58] for example, even a 70-year-old has a greater than 95% chance of surviving two years. Under the 5% probability rule of Treas. Reg. § 26.2632-1(c)(2)(ii)(A), therefore, it should be possible, in many if not most cases, to allocate GST exemption to a short-term GRAT as of the date of creation.

The failure of the ETIP rule to prevent allocation of GST exemption to many GRATs, however, does not mean that GRATs are favored vehicles of GST tax planning. It is tempting to assume that, if GST exemption can be allocated to a GRAT as of inception, the amount of the exemption can be allocated solely to the value of the remainder interest, so that the remainder passes free of GST tax at the end of the GRAT's fixed term. But Treas. Reg. § 26.2632-1(c)(2)(ii)(A) nowhere suggests that taxpayers may allocate GST exemption solely to the value of a remainder interest in a GRAT. Nor does the definition of "applicable fraction" permit the denominator of the applicable fraction – *i.e.*, the value of the property transferred – to be reduced by the value of an interest retained by the taxpayer, such as an annuity interest in a GRAT.[59] On the contrary, as Treasury regulations elsewhere make clear, the value of any property transferred to a GRAT and, therefore, the denominator of the applicable fraction, includes both the value of the retained annuity interest and the remainder interest.[60]

Thus, in order to achieve an applicable fraction of one in the case of a GRAT, the grantor must allocate GST exemption equal to the entire value of the property transferred, not just the value of the remainder interest. If the grantor does allocate that much GST exemption, however, then most, if not all, of the exemption will be wasted in the form of annuity payments back to the grantor, who is not a skip person with respect to himself or herself. An allocation of a GST exemption to a GRAT as of the date of inception, in short, is an especially inefficient use of the grantor's GST exemption.[61] It turns out that Treas. Reg.

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58 These tables are prescribed decennially by the Service pursuant to section 7520 of the Code. Tables with a mortality component may not be used to determine the value of an interest measured by the life of a terminally ill individual. Treas. Reg. § 20.7520-3(b)(3).

59 *See* Treas. Reg. § 26.2632-1(c)(2)(ii)(A).

60 Treas. Reg. § 26.2652-1(a)(5) (ex. 9) (concluding spouse who consents to split gifts for the year is treated as the transferor of one-half of the property transferred to the GRAT, even though the gift of the remainder interest was less). A complete discussion of the issues relating to allocation of GST exemption to GRATs is beyond the scope of this article. For the full "proof" that it is not possible to allocate GST exemption solely to the remainder of a GRAT, *see* Austin W. Bramwell, *Generation-Skipping Transfer Tax Consequences of GRATs: Finding the Answers,* 114 J. TAX'N 260 (2011).

61 *See* I.R.C. § 7520. In addition, in the case of a CLAT, Congress permitted GST exemption allocated to a CLAT to be increased during the fixed term at a rate equal to

§ 26.2632-1(c)(2)(ii)(A) not only does not permit leveraging of a taxpayer's GST exemption but is a trap for naïve planners.

In PLR 200107015, the Service was concerned, as we have seen, that the taxpayers were attempting to pass returns in excess of the section 7520 rate free of GST tax in a manner that Congress had forbidden by enacting section 2642(e) of the Code.[62] Yet returns in excess of the section 7520 rate can no more be passed free of GST tax by allocating GST exemption to GRATs than by allocating GST exemption to CLATs. The blame lies not, as popularly assumed, with the ETIP rule. (If anything, the ETIP rule is the taxpayer's friend, as it prevents, where it applies, inefficient allocations of GST exemption to a GRAT.) Rather, the reason that taxpayers should almost always avoid allocating GST exemption to GRATs as of inception is that, under the general definition of "applicable fraction," such an allocation, where allowed, will be wasted in the form of annuity payments to the grantor. GRATs, in short, do not permit leveraging of GST exemption. Consequently, by the reasoning of PLR 200107015, the same concerns that taxpayers should not be able, through gifts of remainder interests, to leverage gifts of remainder interests for GST tax purposes, should apply to GRATs as much as to CLATs.

E. PLR 200107015 and Gifts of Other Beneficial Interests

Commentators have not generally considered how the policy-based reasoning of PLR 200107015 would apply to trusts that are neither CLATs nor GRATs. Once again, however, although the ruling focuses narrowly on the rule of section 2642(e) of the Code, its more general policy concerns are relevant outside of the facts described in the ruling. Consider, once again, the following example:

> <u>Example 4</u>: G1 creates a trust under G1's will that permits income or principal to be paid over to G2a during G2a's life in the absolute discretion of the trustee. Upon G2a's death, the remainder is to be paid over to G2b or G2b's estate. G2b makes a gift of the remainder interest to G3. The assignment is effective under local law.

According to the displacement theory, G2b in this example should displace G1 as the transferor of any property distributed to G3. Thus, upon G2a's death, even though G3 receives all of the property of the trust and G3 is a skip person with respect to G1, no GST tax is imposed.

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the Section 7520 rate. By contrast, GST exemption allocated to a GRAT is not increased by interest at the Section 7520 rate.

62 *See* PLR 200107015 (Nov. 14, 2000).

Example 4 does not involve a CLAT and, therefore, does not "have the effect of circumventing the rules of section 2642(e)"[63] of the Code, as the Service put it in PLR 200107015. Nevertheless, Example 4 still raises serious policy concerns. In particular, as discussed in part VI.C of this article, *supra*, the displacement theory, if sound, would permit taxpayers to circumvent not just the narrow rule of section 2642(e) of the Code, but the GST tax generally.

To elaborate, if G1 had originally named G3 as the remainder beneficiary upon G2a's death, then a taxable termination subject to GST tax would clearly occur upon G2a's death. Yet, according to the displacement theory, that tax can be avoided altogether if instead G2b is named as the remainder beneficiary and G2b assigns the remainder interest to G3. This favorable result is allegedly achieved even though the value of G2b's gift for gift tax purposes may, it seems, be reduced to reflect the fact that the remainder interest could be curtailed or even defeated by a distribution of the entire property of the trust to G2a. In other words, according to the displacement theory, at the cost of a *de minimis* taxable gift, the entire property of the trust can pass to skip persons free of GST tax.

It seems implausible that the GST tax could be so easy to avoid. (Indeed, the abusive implications of the displacement theory are so startling as to raise doubts as to whether the advocates of the theory actually believe it to be true.[64]) The general concern that the Service expressed in PLR 200107015 that taxpayers should not be permitted to avoid GST tax through assignments of beneficial interests, therefore, is relevant outside the CLAT context, even if the specific rule of section 2642(e) of the Code is not. To prevent taxpayers from circumventing the GST tax, the displacement theory should be rejected as a general matter, just as it should be rejected in the case of CLATs and GRATs.

In summary, in PLR 200107015, the Service was concerned that the taxpayers' displacement theory would violate the policies underlying the GST tax rules. As the facts of PLR 200107015 happened to involve a CLAT, the Service focused on one rule in particular, namely, the special rule of section 2642(e) of the Code, which governs the determination of the applicable fraction in the case of a CLAT. The focus on that rule, however, should not blind readers to the broader policy concerns implicated by the displacement theory. The displacement theory, if sound,

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[63] PLR 200107015 (Nov. 14, 2000).

[64] Note that taxpayers can be held liable for a negligence penalty if they fail "to make a reasonable attempt to ascertain the correctness of a deduction, credit or exclusion on a return which would seem to a reasonable and prudent person to be 'too good to be true' under the circumstances." Treas. Reg. § 1.6662-3(b)(1)(ii). Taken to its logical extreme, the displacement theory, perhaps, violates the "too-good-to-be-true" standard.

would not only permit taxpayers to circumvent section 2642(e) of the Code but would essentially permit them to avoid the tax altogether. The Service, therefore, should not be expected to accept the displacement theory in any context, whether involving CLATs, GRATs, or any other type of trust.

V. Technical Flaws of the Displacement Theory

In PLR 200107015, the Service failed to identify any reasons for rejecting the displacement theory that were based on the text of the Code or Treasury regulations. Instead, the Service objected to the theory solely on policy grounds. The casual reader, in consequence, might assume that, but for some scruples about public policy, the displacement theory would be technically correct.

But the Service's reliance on policy is misleading. As the Service foresaw, albeit dimly, the displacement theory could easily be abused. The potential abuses under the displacement theory, however, are not the only or even the primary reason to reject it. As discussed below, the technical flaws of the displacement theory appear to be fatal even if the theory were consistent with public policy.

A. Displacement Theory, Substance and Form

As will be seen, an important threshold question is whether the displacement theory respects the form of a distribution made from a trust to a donee beneficiary or instead disregards form in favor of the purported substance of the distribution. The following example highlights that issue:

> <u>Example 5</u>: G1 makes a gift of a portfolio of bonds and fixed income investments to an irrevocable trust. The trustee is directed to pay over $40,000 annually to each of G1's children, G2a and G2b, and G1's grandson, G3a. G2b later makes a gift of her annuity interest to G1's granddaughter, G3b. The assignment is effective under local law. After G2b's gift becomes effective, the trustee sells the bond portfolio and reinvests in equities, including 1,200 shares of Apple, Inc. The trustee then satisfies the annuity payments in kind by distributing 400 of the Apple, Inc. shares to each of G2a, G3a, and G3b.[65]

Here, 400 Apple, Inc. shares are distributed to each of three individuals. One of them, G2a, is not a skip person with respect to G1, the original

[65] Although outside the scope of this article, it is worth mentioning that the distribution in kind may trigger gain recognition under *Kenan v. Commissioner*, 114 F.2d 217, 220 (2d Cir. 1940) and Treas. Reg. § 1.661(a)-2(f). No deductions shall be allowed in respect of any loss under I.R.C. § 267.

transferor of the trust. Thus, no matter the correct resolution of the dueling transferors problem, the distribution to G2a should not be subject to GST tax upon the distribution of the Apple, Inc. shares.

The other two distributees, namely, G3a and G3b, are skip persons with respect to the original transferor. G3a was one of the originally named beneficiaries of the trust. That is, unlike G3b, G3b did not receive his interest in the trust by gift from a person other than the original transferor. Consequently, it seems that, even under the displacement theory, G1, as the transferor of the trust, is properly treated as the transferor of the Apple, Inc. shares distributed to G3a. Thus, even according to displacement theory, the distribution of Apple, Inc. shares to G3a should be treated as a taxable distribution subject to GST tax.

By contrast, according to the displacement theory, G1 should not be treated as the transferor of any property distributed to G3b. Rather, G2b, as the individual from whom G3b received the annuity interest, should be treated as the transferor of any amounts that are paid over to G3b by the trustee. After all, advocates of the displacement theory might reason, G2b did not need to assign an annuity interest to G3b in order to cause G3b to receive $40,000 a year. Instead, G2b could have retained the annuity interest and paid $40,000 of cash directly to G3b each year, perhaps immediately upon receipt of the annual annuity payments from the trust. The economic result would be the same in that case as in the facts of Example 5: just as in Example 5, G2b's wealth would be depleted and G3b's wealth increased by $40,000 annually.

Furthermore, if G2b did make a gift of $40,000 every year to G3b, there clearly would not be a direct skip transfer subject to GST tax. After all, G3b is not a skip person with respect to G2b. Thus, annual gifts by G2b to G3b would not be subject to GST tax. Likewise, one might plausibly argue, there should be no GST tax consequences if G2b, as in Example 5, assigns the annuity interest to G3b. Rather, just as if G2b made gifts of $40,000 directly to G3b each year, G2b should be viewed as the true source of the wealth passing to G2b. Therefore, according to this reasoning, distributions from the trust to G3b should not be treated as taxable distributions subject to GST tax.

Note that, in the case of all three annuity distributions in Example 5, the trustee pays over 400 Apple, Inc. shares directly to the beneficiary. In the case of the distribution to G3a, who is one of the originally named beneficiaries, tax treatment follows form: G1 is the transferor of the property held in the trust; G3a, an originally named beneficiary of the trust, is a skip person with respect to G1; therefore, the distribution of 400 Apple, Inc. shares from the trust to G3a should, even under the displacement theory, be treated as a generation-skipping transfer subject to GST tax. By contrast, despite that G1 is the transferor of the property held in the trust, and G3b is a skip person with respect to G1, distributions from the trust to G3b should *not*, according to displacement theory, be treated as generation-skipping transfers. Rather, G3b should be treated, in substance, as receiving her distributions from G2b.

In other words, the displacement theory deems the distribution to G3b in Example 5 to consist of two separate transfers. First, the Apple, Inc. shares are deemed distributed to G2b. As G2b is not a skip person with respect to G1, the deemed distribution is not subject to GST tax. Second, the shares are deemed transferred by G2b to G3b. As G3b is not a skip person with respect to G2b, the deemed transfer by G2b is likewise not subject to GST tax. By analyzing Example 5 in this fashion, the displacement theory is able to conclude that the distribution of Apple, Inc. shares to G3b is not a taxable distribution, even though a distribution of the exact same property to G3a, an individual in the same generation as G3b, is a taxable distribution subject to GST tax.

In reality, of course, G2b neither receives Apple, Inc. shares from the trustee nor pays them over to G3b. Rather, the trustee of the trust makes distributions directly to G3b without routing them through G2b. (Conceivably, G2b would not even be aware of the trustee's decision to distribute any property to the beneficiaries.) The displacement theory's analysis, in short, disregards form in favor of the purported substance of the transaction. Although, formally, the payment of the Apple, Inc. shares is made by the trustee to the substitute, donee beneficiary, the displacement theory treats the distribution as if it came from the former, donor beneficiary.

The displacement theory's claim to have captured the substance or essence of any distributions that are made to a beneficiary who received his or her interest by gift is, perhaps, questionable. In Example 5, the view that G2b is the true source of the Apple, Inc. shares paid over to G3b ignores the fact that G2b would not have been able to assign an annuity interest to G3b in the first place if G1 had not created the trust in question. Rather than view G2b as the transferor of any distributions from the trust to G3b, one could, perhaps, just as plausibly view G2b as a mere conduit for carrying out the disposition of the property that was originally placed in trust by G1.[66] In that view, G1, rather than G2b, should be considered, in substance, as the true transferor of any distributions to G3b.

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66 *Cf.* Self v. United States, 142 F. Supp. 939, 941-42 (Ct. Cl. 1956) (holding that the exercise of power of appointment over corpus should not be treated as a gift, even though the donee of the power effectively relinquished the right to income from the appointed property).

In any event, regardless of whether the displacement theory correctly identifies the substance of a distribution to a donee beneficiary, the theory relies, by necessity, on a substance-over-form argument. That is, the displacement theory assumes that a beneficiary of a trust who receives his or her interest by assignment from a former, donor beneficiary should be treated as receiving distributions not from the trust but from the former beneficiary. As discussed below, the assumption is difficult to sustain.

B. Substance-over-Form Doctrine not Available to Taxpayers

The displacement theory's reliance on substance over form, while intuitively plausible to many, is unlikely to prevail. The reason is that the theory violates "the established tax principle that a transaction is to be given its tax effect in accord with what actually occurred, and not in accord with what might have occurred."[67] Consider, once again, the facts of Example 5:

> Example 5: G1 makes a gift of a portfolio of bonds and fixed income investments to an irrevocable trust. The trustee is directed to pay over $40,000 annually to each of G1's children, G2a and G2b, and G1's grandson, G3a. G2b later makes a gift of her annuity interest to G1's granddaughter, G3b. The assignment is effective under local law. After G2b's gift becomes effective, the trustee sells the bond portfolio and reinvests in equities, including 1,200 shares of Apple, Inc. The trustee then satisfies the annuity payments in kind by distributing 400 of the Apple, Inc. shares to each of G2a, G3a, and G3b.

Here, G3b receives a gift of an annuity interest from G2b. Thereafter G3b receives Apple, Inc. shares directly from the trustee. As discussed, the same result, in an economic sense, could have been obtained had G2b not made a gift of her annuity interest to G3b but had instead retained the interest and paid over $40,000 annually to G3b. In that case, the value of G2b's gifts to G3b over time would be the same as the value of G2b's gift of the annuity interest.[68] Furthermore, there would clearly be no GST tax imposed in that case: as G3b is not a skip person with respect to G2b, the hypothetical $40,000 annual gifts by G2b to G3b would not be direct skip gifts subject to GST tax. As no GST tax would be due had G2b chosen to make annual gifts to G3b, no GST tax should

[67] *See* Comm'r. v. Nat'l Alfalfa Dehydrating & Milling Co., 417 U.S. 134, 148 (1974).

[68] Gifts made over time will tend to be more gift tax efficient, as gifts in each year will qualify for the gift tax annual exclusion, whereas a single gift of an annuity interest will qualify for the gift tax annual exclusion only once.

be due, according to displacement theory, upon a distribution directly from the trust to G3b.

But the fact that the donor of an interest in a trust could have achieved the same result another way, without incurring GST tax, does not mean that GST tax should not be imposed on the actual series of transactions that ensue from the donor's gift of an interest. Courts have not been receptive to taxpayer efforts to disregard form in favor of alleged substance. As Judge Learned Hand wrote in *United States v. Morris & Essex R. Co.*,[69] "the Treasury may take a taxpayer at his word . . . but that is a rule which works only in the Treasury's own favor; it cannot be used to deplete the revenue."[70]

The leading case of *Commissioner v. National Alfalfa*,[71] is instructive. In *National Alfalfa*, the taxpayer, a corporation, purchased stock from preferred shareholders in exchange for debt instruments. The face amount of the debt instruments was greater than the price of the stock. In other words, the instruments were issued at a discount, commonly called an "original issue discount," from their face amounts.[72] At the time of *National Alfalfa*, as now, a taxpayer was generally entitled to a deduction under section 163 of the Code on original issue discount accrued on debt issued for cash.[73] But it was unclear at the time of *National Alfalfa* whether a deduction for original issue discount was available for debt issued in exchange for preferred shares.[74]

The taxpayer in *National Alfalfa* offered a substance-over-form argument to justify a deduction for the original issue discount. According to the taxpayer, it could have achieved the same result in two stages: first, it could have issued the debt instruments in question on the open market in exchange for cash; second, it could have used the cash to purchase the preferred stock back from the stockholders.[75] In that case, since the debt instruments would have been issued for cash, the taxpayer would have clearly been entitled to a deduction for original issue discount.[76] To deny the same deduction for debt instruments issued directly in exchange for the preferred shares would, the taxpayer argued,

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69 United States v. Morris & Essex R. Co., 135 F.2d 711, 713 (2d Cir. 1943).

70 *See Morris*, 135 F.2d at 713; *see also* Higgins v. Smith, 308 U.S. 473, 477 (1940) ("A taxpayer is free to adopt such organization for his affairs as he may choose, and having elected to do some business as a corporation, he must accept the tax disadvantages.").

71 *Nat'l Alfalfa*, 417 U.S. 134 (1974).

72 *Id.* at 143-44.

73 *Id.* at 136.

74 *Id.* at 136, 143-44.

75 *Id.* at 147-48.

76 *Id.* at 148.

have resulted in a different tax treatment of an economically identical transaction.[77]

The court rejected this argument. A taxpayer, the court observed, "may not enjoy the benefit of some route he might have chosen to follow but did not."[78] On the contrary, having selected a particular course, "he must accept the tax consequences of his choice."[79] The court noted that there was no telling from the record in *National Alfalfa* at what price the taxpayer would have been able to issue debt instruments for cash, nor whether the taxpayer would have been able to purchase the preferred stock on the open market.[80] In light of these uncertainties, the court refrained from engaging in the type of speculation into hypotheticals proposed by the taxpayer.[81]

As we have seen, the displacement theory argues that a substitute, donee beneficiary should be treated as if he or she receives any distributions not from the trust but from the former, donor beneficiary. After all, the reasoning goes, the donor of the interest could have achieved the same result by remaining the beneficiary and immediately transferring any distributions over to the donee. But that is not the form of the gift that the donor actually selects when making a gift of a beneficial interest. Under *National Alfalfa*, courts may not aid taxpayers to obtain the favorable tax consequences that they would have obtained in a different, though economically similar, transaction.[82] The substance-over-form reasoning of the displacement theory, in short, is precluded.

Furthermore, the rationale of *National Alfalfa* is especially compelling in the case of gifts of beneficial interests in trust. Consider, once again, the facts of Example 4:

> <u>Example 4</u>: G1 creates a trust under G1's will that permits income or principal to be paid over to G2a during G2a's life in the absolute discretion of the trustee. Upon G2a's death, the remainder is to be paid over to G2b or G2b's estate. G2b makes a gift of the remainder interest to G3. The assignment is effective under local law.

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77 *Id.*

78 *Id.* at 149.

79 *Id.*

80 *Id.* at 149-50.

81 *See id*. By contrast, it is well settled that the Service may invoke the substance-over-form doctrine in order to deny a tax benefit. *See also, e.g.*, Gregory v. Helvering, 293 U.S. 465, 468-70 (1935); Helvering v. F. & R. Lazarus & Co., 308 U.S. 252, 255 (1939) ("In the field of taxation, administrators of the laws and the courts are concerned with substance and realities, and formal written documents are not rigidly binding.").

82 Comm'r. v. Nat'l Alfalfa Dehydrating & Milling Co., 417 U.S. 134, 149 (1974).

Upon G2a's death, all of the property of the trust will be paid over to G3, who is a skip person with respect to G1. Nevertheless, the displacement theory holds that the termination of the trust should not be a taxable termination subject to GST tax. Rather, the trust should be treated as if it terminated in favor of G2a, who immediately transfers the remaining property over to G3. After all, G2a could have achieved the same result by holding onto the remainder interest and, upon G2a's death, making a gift of the remainder property to G3. In that case, no GST tax would have been imposed.

The displacement theory's analysis, however, engages in just the sort of speculation into hypotheticals against which the court cautioned in *National Alfalfa*.[83] Indeed, the speculation is arguably greater than that in which the court declined to engage in *National Alfalfa*. At least in *National Alfalfa*, the taxpayer proposed that the court analyze the tax results of the actual transaction by reference to a hypothetical, alternative transaction that could have occurred *at the same time* as the actual transaction.[84] The displacement theory, by contrast, would ask the court to analyze the tax consequences of a gift of a beneficial interest by reference to a hypothetical, alternative transaction that would necessarily occur *at a later time*.

Specifically, the displacement theory assumes that the donor of a beneficial interest would, instead of making a present gift of the interest, make future gifts to the donee equal to the distribution amounts paid over from the trust. In Example 4, for example, the displacement theory argues that G2b's gift of a remainder interest should be treated for GST tax purposes as if G2b had not made the gift but instead, upon termination of the trust, had immediately made a gift to G3 of the property distributed from the trust to G2b. As G3 is not a skip person with respect to G2b, no GST tax would be imposed on such a gift. In like fashion, according to the displacement theory, a GST tax should not be imposed as a result of G2b's actual gift of the remainder interest.

But just because a donor is willing to make a gift now of a beneficial interest does not mean that he or she would be similarly willing in the future to make gifts of all distributions made from the trust. In Example 4, the value of the property that will be left over upon termination of a trust is highly speculative. If the trustee chooses to make substantial distributions to G2a, then little or no corpus will be left to be paid over to the remainderman; conversely, if the trustee makes no distributions to G2a, the remainderman will receive a windfall. By contrast, a gift of whatever property is actually remaining at G2a's death would be a gift of a then-certain amount. Conceivably, G2b would be

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83 *Id.*
84 *See id.* at 147-48.

willing to make a gift to G3 now of the remainder interest in the trust, yet would not be willing in the future to make a gift to G3 of the property that actually becomes distributable upon termination of the trust.

In short, the displacement theory would require courts to make speculative assumptions about a donor's propensity to make gifts in the future of property that is different in kind from the property the donor actually transferred. That is, it requires courts to hazard a guess that a donor who makes a gift of a beneficial interest in a trust would also, in lieu of that gift, make future gifts of all distributions that would otherwise have been made from the trust to the donor. Under *National Alfalfa*, that is precisely the sort of boundless inquiry into hypothetical transactions that courts are obligated to avoid.

C. Misidentification of the Property of Which the Donor of a Beneficial Interest is the "Transferor"

The displacement theory rests on a simple intuition: namely, that an individual who makes a gift of a beneficial interest in trust property should be treated as the transferor not only of the beneficial interest but also of any distributions to the substitute, donee beneficiary. In other words, to borrow a metaphor from the income tax context,[85] the donor should be treated, for GST tax purposes, as the transferor of both the "tree" (*i.e.*, the beneficial interest in the trust) and the "fruits" (*i.e.*, the distributions received by the donee). Example 5 illustrates the intuition:

> Example 5: G1 makes a gift of a portfolio of bonds and fixed income investments to an irrevocable trust. The trustee is directed to pay over $40,000 annually to each of G1's children, G2a and G2b, and G1's grandson, G3a. G2b later makes a gift of her annuity interest to G1's granddaughter, G3b. The assignment is effective under local law. After G2b's gift becomes effective, the trustee sells the bond portfolio and reinvests in

[85] The metaphor has, perhaps, been most commonly invoked in order to explain the anticipatory-assignment-of-income doctrine. In *Helvering v. Horst*, 311 U.S. 112, 114, 116, 120 (1940), for example, a bond holder gave the interest coupons on a bond to his son, who later collected the interest payments on maturity. The court, stating that "the fruit is not to be attributed to a different tree from that on which it grew," held that the bondholder, rather than the son, was taxable on the interest payments. *Id.* at 120. *See also* Lucas v. Earl, 281 U.S. 111, 115 (1930) ("[No] distinction can be taken according to the motives leading to the arrangement by which the fruits are attributed to a different tree from that on which they grew."). The metaphor of tree and fruits has also been used to explain the distinction between income and capital. Eisner v. Macomber, 252 U.S. 189, 206 (1920) ("The fundamental relation of 'capital' to 'income' has been much discussed by economists, the former being likened to the tree or the land, the latter to the fruit or the crop; the former depicted as a reservoir supplied from springs, the latter as the outlet stream, to be measured by its flow during a period of time.").

> equities, including 1,200 shares of Apple, Inc. The trustee then satisfies the annuity payments in kind by distributing 400 of the Apple, Inc. shares to each of G2a, G3a, and G3b.

Here, G2b makes a gift of an annuity interest to G3b, who thereafter receives annuity payments from the trustee. According to the displacement theory, because G2b is the transferor of the annuity interest, G2b should also be the treated as the transferor of any payments by the trustee to G3b, including the payment of the 400 Apple, Inc. shares distributed by the trustee to G3b. In other words, the theory holds, G2b is the transferor not only of the "tree" (*i.e.*, the annuity interest) but also of the fruits (*i.e.*, all distributions received by G3b, including the 400 Apple, Inc. shares paid over to G3b).

As it happens, in the income tax context, the courts have already rejected the notion that an individual who transfers a beneficial interest to another should also be treated as having transferred any subsequent distributions. In the seminal case of *Blair v. Commissioner*,[86] the settlor named his son as the initial income beneficiary of a trust.[87] The son thereafter effectively assigned his income interest down a generation to his own children, the settlor's grandchildren. As a result, the grandchildren, rather than the son, received the income paid over by the trustee. The Service nevertheless argued that the son, as the donor of the income interest, should be treated as having realized the income himself under the anticipatory-assignment-of-income doctrine of *Lucas v. Earl*.[88] The son, by contrast, argued that the grandchildren, as the beneficiaries of the trust, realized the income and, therefore, should be the ones taxed.

Put another way, the Service and the taxpayer disagreed on the source of the income received by the grandchildren. According to the Service, the son not only assigned the right to receive trust income – *i.e.*, the "tree" – but also should be treated as having assigned whatever amounts of income – *i.e.*, the "fruits" – were paid over by the trustee.[89] Thus, in the Service's view, the income that, in reality, was paid over to the grandchildren by the trustee should nevertheless be deemed to have

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86 Blair v. Comm'r., 300 U.S. 5, 7 (1937).

87 *Id.*

88 *Id*. at 7, 11; *see also Lucas*, 281 U.S. at 113-15. In *Lucas*, an attorney had promised his wife that she should be entitled to a portion of his earnings. The court held, however, that the income tax could "not be escaped by anticipatory arrangements and contracts however skillfully devised to prevent the salary when paid from vesting even for a second in the man who earned it." *Id.* at 115. Thus, for income tax purposes, the earnings were taxed solely to the attorney and not to his wife. *Id.* at 113-15.

89 *Blair*, 300 U.S. at 12-13.

been paid over by the son. In other words, the income should be deemed to have been realized and paid over by the son.

The son, by contrast, argued that just because he had assigned a right to income did not mean that he had assigned whatever amounts of income were subsequently paid over by the trustee. That is, according to the son, he had merely transferred the "tree," *i.e.*, the income interest. By doing so, he had relinquished the subsequently realized fruits, *i.e.*, the income distributions. Thus, according to the son, the income distributed by the trustee to the grandchildren should be taxed to the grandchildren, as the beneficial owners of the income.

The court in *Blair* held for the son.[90] According to the court, the settlor's grandchildren, as the beneficiaries of the trust for state law purposes and proper recipients of the income paid over by the trustee, should likewise be treated as the recipients of the income for income tax purposes.[91] As the majority put it, "The one who is to receive the income as the owner of the beneficial interest is to pay the tax."[92] Distributions of income are not, therefore, treated as if they had been assigned by the former, donor beneficiary. Rather, the beneficiary is taxed on the income, even if the beneficiary obtained the right to the income by gift from a former beneficiary.

Three years later, in *Helvering v. Horst*,[93] the court clarified and confirmed its holding in *Blair*. In *Horst*, a bondholder had assigned to his son the interest coupons on a bond. The court held that, having retained the bond, the bondholder (and not his son) should be taxed on the interest payments, for "the fruit is not to be attributed to a different tree from that on which it grew."[94] In distinguishing *Blair*, the court noted that the taxpayer in *Blair*, unlike the taxpayer in *Horst*, had assigned the underlying property right that generated the income, namely, the right to "equitable ownership" in trust property.[95] Consequently, wrote the court in *Horst*, "[t]he income of the trust [in *Blair*] was regarded as no more the income of the donor than would be the rent from a lease or a crop raised on a farm after the leasehold or the farm had been given away."[96] In other words, the son in *Blair*, having assigned a beneficial interest in the trust property, should not be deemed to have received and paid over the fruits of that interest. Thus, the income paid

90 *Id.* at 14.
91 *Id.*
92 *See id.* at 12.
93 Helvering v. Horst, 311 U.S. 112, 118-19 (1940).
94 *Id.* at 120.
95 *Id.* at 118.
96 *Id.* at 119.

over by the trustee to the donees in *Blair* was properly taxed to the donees and not to the donor.

The displacement theory attempts to resurrect on behalf of taxpayers the same theory that, in the income tax context, was rejected by the Supreme Court in *Blair* and again in *Horst*. That is, the displacement theory, like the Service in *Blair*, attempts to treat the transferor of a beneficial interest in a trust not only as having transferred the beneficial interest but also as having received and paid over any distributions to the donee beneficiary. A close reading of the Code's definition of "transferor," however, reveals that the theory works no better in the GST tax context than it did in the income tax context. That definition is as follows: "In the case of any property subject to the tax imposed by chapter 11, the decedent, and . . . in the case of any property subject to the tax imposed by chapter 12, the donor."[97] The foregoing definition of "transferor" has a *res* element: that is, for there to be a transferor for GST tax purposes, there must also be a thing –"property" – that was transferred. In addition, the definition limits the *res* in question: for an individual to be treated as the "transferor" of property, the property must have been "subject to" gift or estate tax. As Treasury regulations put it, the transferor is "the individual with respect to whom *property* was most recently *subject to* Federal estate or gift tax."[98]

The GST tax provisions provide only limited guidance on what it means for property to have been "subject to" gift (or estate) tax.[99] The principles set forth in the gift tax regulations, however, bear directly on the question. In particular, Treas. Reg. 25.2511-2(a) distinguishes between the "act of making the transfer" by gift, which is subject to gift tax, and the "enrichment resulting to the donor," which is not. The regulation states,

> The gift tax is not imposed upon the receipt of the property by the donee, nor is it necessarily determined by the measure of enrichment resulting to the donee from the transfer, nor is it conditioned upon ability to identify the donee at the time of the transfer. On the contrary, the tax is a primary and personal liability of the donor, is an excise upon his act of making the transfer, is measured by the value of the property passing from the donor, and attaches regardless of the fact that the identity of the donee may not then be known or ascertainable.

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97 I.R.C. § 2652(a)(1).

98 Treas. Reg. § 26.2652-1(a)(1) (emphasis added).

99 A transfer is "subject to" gift tax if a gift tax imposed, without regard to exemptions, exclusions, deductions, and credits. Treas. Reg. § 26.2651-2(d). The regulations do not address whether, following a gift of a beneficial interest, subsequent distributions are deemed to be "subject to" gift tax, just like the gift of the beneficial interest itself.

In other words, only "the act of making the transfer" of property by gift is subject to gift tax. The donee's enrichment, by contrast, is incidental and is not the subject of the tax.

The distinction, in the gift tax context, between "the value of the property" transferred and the "measure of enrichment resulting to the donee" echoes the distinction between "tree" and "fruits" in the income tax context.[100] For gift tax purposes, an individual who transfers property by gift is taxed on the value of the property transferred and not on the degree of enrichment to the donee. In other words, gift tax is imposed on the transfer of the "tree" rather than the realization of the "fruits." Likewise, for income tax purposes, a donor of property, like the taxpayer in *Blair*, is treated as having assigned the property itself and not also as having received and then assigned the fruits.

The distinction between the property that is subject to gift tax and the enrichment to the donee, or between "tree" whose transfer is subject to gift tax and the later realization of the "fruits," helps clarify what, exactly, is subject to tax when an individual makes a gift of a beneficial interest in a trust. Suppose, for example, that, as in *Blair*, the settlor creates a trust of which the settlor's son is initially entitled to the income. The son then, as in *Blair*, irrevocably assigns the income interest to his own children. As the son makes a transfer of property by gift, a gift tax would be imposed on the son's act of assigning the income interest.[101] In the language of the GST tax provisions, the income interest is the property whose transfer is "subject to" gift tax.

Following the son's gift, the children should begin to receive the income of the trust. The amount of income that the children will ultimately receive depends on a complex interplay of factors, including the extent to which the trustee invests for income, the trustee's exercise of discretion in making allocations between income and principal (including the exercise of any power to adjust between the two), the trustee's diligence in collecting and paying income, and the children's zeal in enforcing their rights. In any event, regardless of the extent of the distributions to the children, the distributions themselves are not themselves subject to gift tax. As Treas. Reg. 25.2511-2(a) states, the gift tax is not

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[100] Of course, one must be cautious about importing income tax concepts into the gift, estate and GST tax context(s). Famously, for example, a gift means one thing in the income tax context and another thing is the gift tax context. Comm'r v. Beck's Estate, 129 F.2d 243, 246 (2d Cir. 1942) ("Perhaps to assuage the feelings and aid the understanding of affected taxpayers, Congress might use different symbols to describe the taxable conduct in the several statutes, calling it a 'gift' in the gift tax law, a 'gaft' in the income tax law, and a 'geft' in the estate tax law.") Here, it so happens that the distinction between "tree" and "fruits" is found in both areas of tax.

[101] The son's gift will qualify at least in part for the gift tax annual exclusion. Treas. Reg. § 25.2503-3(b).

determined by the measure of enrichment to the donees. Rather, the gift tax is imposed on the transfer of the "tree" – *i.e.*, the beneficial interest – but not on the realization of the "fruits" – *i.e.*, distributions to the donees.

The displacement theory nevertheless assumes that the donor of a beneficial interest should be treated as the "transferor" not only of the beneficial interest but of all subsequent distributions to the donee beneficiaries. But it is literally untrue that distributions from a trust to donee beneficiaries are "subject to" gift tax. Rather, as we have seen, gift tax is imposed on the act of transferring property by gift, but not on any subsequent enrichment of the donees. The displacement theory's assumption that, following a gift of a beneficial interest, distributions to the donee beneficiaries are subject to gift tax and, therefore, that the donor is the "transferor" of those distributions, appears to be incorrect. In essence, the displacement theory holds that an individual can be treated as the "transferor" of property *other* than the property that was actually transferred. That position is difficult to sustain in light of the Code's definition of "transferor."

Who then should be treated as the transferor of distributions from a trust to a beneficiary who received his or her interest by gift from a former beneficiary? Consider, once again, the facts of Example 5:

> Example 5: G1 makes a gift of a portfolio of bonds and fixed income investments to an irrevocable trust. The trustee is directed to pay over $40,000 annually to each of G1's children, G2a and G2b, and G1's grandson, G3a. G2b later makes a gift of her annuity interest to G1's granddaughter, G3b. The assignment is effective under local law. After G2b's gift becomes effective, the trustee sells the bond portfolio and reinvests in equities, including 1,200 shares of Apple, Inc. The trustee then satisfies the annuity payments in kind by distributing 400 of the Apple, Inc. shares to each of G2a, G3a, and G3b.

Here, G3a is a skip person with respect to G1. Unlike G3b, G3a did not receive his annuity interest in the trust by gift from a former beneficiary but is one of the originally named beneficiaries. Thus, as discussed previously, even according to the displacement theory, G1 is correctly identified as the "transferor" of the Apple, Inc. shares paid over to G3a.

To be sure, the Apple, Inc. shares were not acquired by the trustee until after the trust was created. In that sense, the shares were not "subject to" gift tax with respect to G1. But that does not mean that G3a avoids GST tax. Although G1 was not "subject to" gift tax on the Apple, Inc. shares specifically, he was "subject to" gift tax on all the property held in the trust, considered in the abstract.[102] As Treasury regulations make clear, the transferor of a trust for GST tax purposes is treated as the transferor of the fraction or portion of trust property attributable to his or her gift or bequest, even if the property changes in value or character.[103] In other words, just as, for state law purposes, the settlor of a trust remains the settlor throughout the lifecycle of a trust, even if the initial *res* is converted into different property, so the "transferor" of a trust for GST tax purposes remains the transferor, even if the initial trust property is converted into property of a different kind.[104] Thus, in Example 5, G1 is unquestionably the "transferor" of the property of the trust, including the Apple, Inc. shares distributed to the beneficiaries, even though G1 did not acquire and transfer the Apple, Inc. shares himself.[105]

Nevertheless, the displacement theory holds that G2b displaces G1 as the transferor of the 400 shares that happen to be distributed to G3b,

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102 *Cf.* Treas. Reg. § 26.2632-1(a) (stating that GST exemption is allocated to the entire trust and not to specific trust assets).

103 *See*, *e.g.*, Treas. Reg. § 26.2654-1(a)(5) (ex. 5-6) (clarifying that, if there are multiple donors of property to the same trust, they are treated as the transferors of fractional portions of trust property, including when the trust property appreciates); *see also* Treas. Reg. § 26.2601-1(b)(1)(iv) (distinguishing between the "non-chapter-13 portion" and the "chapter 13 portion" of a trust where additions are made to an otherwise grandfathered trust); Treas. Reg. § 26.2601-1(b)(1)(v) (treating construction additions to an otherwise grandfathered trust as creating separate portions for GST tax purposes); Treas. Reg. § 26.2652-1(a)(5) (ex. 9 (treating spouses who elect to "split" gifts as the transferors, respectively, of one-half of the trust property).

104 Treasury regulations frequently refer to the "transferor" as the transferor of trust property, trust corpus, or trust assets in the abstract. The identity of the transferor of trust property can also change at a later time when it is subject to gift or estate tax. *See*, *e.g.*, Treas. Reg. § 26.2601-1(b)(1)(iii)(B) (ex. 1); *see also* Treas. Reg. § 26.2601-1(b)(1)(v)(D) (ex. 1-3); Treas. Reg. § 26.2632-1(a).

105 There is no inconsistency between the claim that G1 is the "transferor" of the trust property and the principle that gift tax is not imposed on the degree of enrichment to the donee. To be sure, whereas the gift and estate taxes are imposed on the act of transfer, which occurs at a single moment in time, an individual's status as the "transferor" of trust property persists until termination of a trust. The regulations implementing the GST tax, however, solve the conundrum very simply, by treating the individual who makes the initial transfer of property to a trust as the transferor of trust property in the abstract, rather than the transferor of the specific items with which the trust was initially funded. *See*, *e.g.*, Treas. Reg. § 26.2654-1(a)(5) (ex. 6); *see also* Treas. Reg. § 26.2632-1(a) (stating that GST exemption is allocated to the entire trust and not to specific trust assets). Thus, if trust property appreciates in value, the initial transferor remains the transferor of the entire trust, including all income and appreciation. That does not imply that that transferor is "subject to" gift tax on the degree of enrichment to the donees. It means simply that the *res* with respect to which an individual is considered the transferor is the property of the trust as constituted from time to time. *Cf.* Treas. Reg. § 26.2601-1(b)(1)(vi) (stating that appreciation and income are not considered additions to a trust).

even as G1 remains the transferor of the identical 400 shares that happened to be distributed to G3a. To be considered the "transferor" of any property distributed to the beneficiaries, however, G2b must have been "subject to" gift tax with respect to them. But G2b never actually makes a transfer of any of the 1,200 Apple, Inc. shares acquired by the trustee; indeed, the Apple, Inc. shares are not acquired by the trustee until after G2b assigns her annuity interest to G3b. G2b, therefore, at no point even has a beneficial interest in the Apple, Inc. shares that she even could have transferred by gift to G3b.

G2b does, to be sure, make a gift of an annuity interest in the property of the trust, however constituted from time to time. As discussed, however, G2b is not subject to gift tax on the fruits that interest, namely, distributions made by the trustee to G3b. By contrast, as discussed, G1 was subject to gift tax on all of the trust property, including property distributed to the beneficiaries. Thus, as even the displacement theory concedes, G1 is the transferor of the 400 Apple, Inc. shares paid over to G3a (and G2a). In short, G1's ongoing status as the "transferor" of trust property is unproblematic, as G1 is the individual with respect to whom the trust property was "subject to" gift tax. G2b's putative status as the "transferor" of distributions to G3b, by contrast, appears to run afoul of the principle that an individual cannot be considered the "transferor" of property other than that with respect to which he or she was "subject to" gift tax. Therefore, G1, as a technical matter, is better viewed as the transferor of the Apple, Inc. shares paid over to G3b.

D. Displacement Theory and the Most Recent Transferor Rule

In general, property that was previously subject to gift or estate tax acquires a new transferor for GST tax purposes upon the same property later being subject to gift or estate tax with respect to a new individual. This rule – referred to herein as the "most recent transferor" rule – is implicit in Treas. Reg. § 26.2652-1(a)(1), which defines the transferor as "the individual with respect to whom [the] property was *most recently* subject to Federal estate or gift tax."[106] The phrase "most recently" implies that it is possible for property to have one transferor at one time and a different transferor at a later time.[107]

Treasury regulations confirm that it is possible for the identity of the transferors of property to change. In Treas. Reg. § 26.2652-1(a)(5) Example 3, for example, a "qualified terminable interest property" or "QTIP" trust created by one spouse for the benefit of another was in-

[106] Treas. Reg. § 26.2652-1(a)(1) (emphasis added).

[107] *Id.* It seems that it is not possible for any one trust (provided that it is treated as a separate trust for GST tax purposes) to have more than one transferor at any one time.

cluded in the beneficiary spouse's gross estate under section 2044 of the Code.[108] The example concludes that the spouse displaces the settlor as the transferor of the trust property for GST tax purposes. Similarly, Treas. Reg. § 26.2652-1(a)(5) Example 5 concludes that the exercise or release of a general power of appointment over that property, if treated as a gift for gift tax purposes, will cause the holder of the power to displace the settlor of a trust as the transferor. Both changes of transferor follow from the fact that the underlying trust property was subject to gift or estate tax.

A defender of the displacement theory might argue that a similar change of transferors occurs upon a gift of a beneficial interest. Consider, once again, the facts of Example 5:

> <u>Example 5</u>: G1 makes a gift of a portfolio of bonds and fixed income investments to an irrevocable trust. The trustee is directed to pay over $40,000 annually to each of G1's children, G2a and G2b, and G1's grandson, G3a. G2b later makes a gift of her annuity interest to G1's granddaughter, G3b. The assignment is effective under local law. After G2b's gift becomes effective, the trustee sells the bond portfolio and reinvests in equities, including 1,200 shares of Apple, Inc. The trustee then satisfies the annuity payments in kind by distributing 400 of the Apple, Inc. shares to each of G2a, G3a, and G3b.

In Example 5, G1 is the initial transferor of the trust. After creation of the trust, G2b makes a gift of her annuity interest. According to the displacement theory, G2b's gift of the annuity interest makes her the individual with respect to whom any distributions to G3b were last subject to gift tax. Thus, under the most recent transferor rule, G2b should (according to the displacement theory) be treated as the transferor of the Apple, Inc. shares paid over to G3b.

On closer inspection, however, the displacement theory not only does not follow from the most recent transferor rule but, if anything, departs from it. As discussed previously, the displacement theory agrees that G1 is the "transferor" of the Apple, Inc. shares distributed to G2a and G3a. After all, G2a and G3a did not receive their interests by gift from a former beneficiary but are two of the originally named beneficiaries of the trust. Thus, G1, as the original donor of the trust

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108 "Qualified terminable interest property" is property that qualifies, by an election made by the decedent's executors or by the donor, for the estate or gift tax marital deduction under section 2056(b)(7) or 2523(f) of the Code. Such property is generally included in the spouse's gross estate under section 2044 of the Code (unless it is deemed to have been sooner transferred under section 2519 of the Code). *See* Treas. Reg. § 26.2652-1(a)(5) (ex. 3); I.R.C. § 2044; I.R.C. § 2056(b)(7); I.R. .C § 2519; I.R.C. § 2523(f).

property, is properly treated as the transferor of any distributions to G2a and G3a, including the Apple, Inc. shares.

Meanwhile, although G2b does make a gift of a beneficial interest in trust property, G2b at no point makes a gift of any of the Apple, Inc. shares. Indeed, G2b at no point even acquires a beneficial interest in the Apple, Inc. shares, which are not purchased by the trustee until *after* the G2b assigns her interest in the trust. Nevertheless, the displacement theory treats G2b as the transferor of the 400 Apple, Inc. shares distributed to G3b, even though G1, as the displacement theory admits, is the transferor of the 800 identical Apple, Inc. shares that are distributed to G2a and G3a.

In other words, according to the displacement theory, G2b does not become the transferor of any property of the trust until the moment of distribution. Until that moment, G1 remains the transferor of all of the Apple, Inc. shares when they are acquired and continues to be treated as the transferor right up until the moment of distribution. (Alternatively, perhaps, the displacement theory could view the identity of the transferor of trust property as uncertain or unknown until a distribution actually takes place. In this view, G1's status as the transferor is, in effect, suspended until a distribution is actually made.) Then, at the moment that G3b receives 400 Apple, Inc. shares from the trustee, G2b displaces G1 as the transferor of those shares. Even at that moment, however, G1 remains the transferor of the other 800 Apple, Inc. shares that are distributed to G2a and G3a. The change of transferors with respect to the shares that happen to be paid over to G3b necessarily occurs at the moment that they are distributed.

The notion that a change of transferors occurs at the moment of distribution, however, is inconsistent with the most recent transferor rule. The most recent transferor rule posits that a change in the identity of the transferor of trust property occurs *at the same time* that the property is subject a second time to gift or estate tax. Thus, when QTIP property is included in a beneficiary's gross estate under section 2044 of the Code, or when a beneficiary exercises or releases a general power of appointment over trust property, the beneficiary becomes at that time the new transferor of the underlying trust property. Any change of transferors must, it seems, occur simultaneously with a gift or estate tax event.

A distribution of property from a trust to a beneficiary, however, is not in itself an estate or gift tax event. In Example 5, for example, G1 was the last person with respect to whom the underlying property of the trust – including, up until the moment of distribution, all of the Apple, Inc. shares – was subject to gift or estate tax. The displacement theory nonetheless holds that G2b displaces G1 as the transferor of property at the moment that it is distributed to G3a. But while property held in trust can acquire a new transferor at the moment it becomes subject to gift or estate tax, the distribution to G3b is not a transfer that is subject to gift or estate tax. Thus, it is unclear how a change of transferors could actually occur at the moment of distribution.

To be sure, G2b does make a transfer that is subject to estate or gift tax. In G2b's case, however, the property subject to gift tax is an annuity interest *in* the trust property. The property with respect to which G2b is subject to gift tax is not the underlying trust property but a beneficial interest in that property. The displacement theory's attempt to expand the scope of the most recent transferor rule, in other words, runs into the same technical defect discussed previously: namely, that the displacement theory treats the donor of a beneficial interest as the "transferor" of property *other* than the property that was actually subject to gift or estate tax. That is, notwithstanding *Blair* and *Horst* and the entrenched principle that the gift tax is not imposed on the degree of enrichment to the donee, the displacement theory treats the donor as the transferor not only of the "tree" (the interest transferred) but also of the fruits (the distributions received by the donee from the trust). This basic error then leads the displacement theory to the anomalous result that a change of transferors occurs upon an event — a distribution from a trust – that it is not actually subject to gift or estate tax. There is no need, however, to embrace such an anomaly. The displacement theory is inconsistent with both the definition of "transferor" and the most recent transferor rule.

E. Other Flaws of the Displacement Theory

The displacement theory suffers from flaws other than those discussed in this section. For example, as we will see, it is inconsistent with the definition of "interest in property held in trust,"[109] and is difficult to reconcile with the one example in Treasury regulations that directly addresses the dueling transferors problem. Further, the displacement theory is inconsistent with case law in the gift and estate tax area. These flaws are examined *infra* in sections VII and VIII of this article, respectively.

F. Is There Any Authority in Favor of the Displacement Theory?

The displacement theory occupies a curious position in the GST tax literature. Virtually no authority has ever been cited in support of the

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[109] I.R.C. § 2652(c).

theory,[110] while efforts to distinguish the contrary authority have been merely cursory. Meanwhile, as discussed in prior sections, the abuses that would be created by the theory are so severe as to cast doubt on whether any of the theory's ostensible defenders actually understand their own position. And, as discussed in this section, the theory is inconsistent with the definition of "transferor" and depends on tax fictions that have already been rejected by the courts. The displacement theory seems in many cases to have simply been taken for granted without further analysis.

VI. Critique of the Portion Theory

If the displacement theory is incorrect, what should go in its place? The answer, according to the Service in PLR 200107015 and other rulings,[111] is the portion theory. The portion theory holds that, if a beneficiary makes a gift of his or beneficial interest in a trust, he or she should be treated as having transferred a portion or fraction of the underlying trust property equal to the value of the beneficial interest at the time of the gift, divided by the value of the trust property at the time of the gift. The theory does avoid some of the abuses that would be available under the displacement theory. Nevertheless, although the Service's motives in crafting the portion theory are laudable, it too suffers from technical flaws. In the end, it does not appear that the portion theory is a viable solution to the dueling transferors problem.

A. PLR 200107015 and the Portion Theory

The portion theory was articulated most explicitly in PLR 200001015.[112] There, as discussed *supra* in part IV.C of this article, one of the remaindermen of a testamentary CLAT was a child of the settlor. The child proposed to make a gift of the child's remainder interest to a grandchild of the decedent. The taxpayers argued in favor of the dis-

110 Indeed, the only authority that is cited in favor of the theory is a line of cases in the estate tax area interpreting the meaning of "full and adequate consideration in money or money's worth" for purposes of section 2036(a)(1) of the Code. Treas. Reg. § 20.2036-1. As we shall see, however, not only does this line of cases not support the displacement theory but it is strong indirect contrary authority. *See e.g.* D'Ambrosio v. Comm'r, 101 F.3d 309 (3d Cir. 1996); Gradow v. United States, 897 F.2d 415 (Fed. Cir. 1990).

111 In PLR 200536018 (June 7, 2005), for example, a court-ordered modification of remainder interests in a trust caused some of the remaindermen to have made taxable gifts of their remainder interests. The Service held that each donor of a remainder interest would be treated as the transferor of a portion of the underlying trust property. *See also* PLR 200530002 (Apr. 19, 2005) (ruling that a gift of remainder interest by an income beneficiary caused him to be treated as the transferor of a portion of the underlying trust property).

112 PLR 200001015 (Sept. 30, 1999).

placement theory: that is, they proposed that the child be treated as transferor not only of the remainder interest but also of any property ultimately distributed to the decedent's grandchildren at the end of the fixed term.

The Service rejected the displacement theory on policy grounds. Rather than treat the donor of the remainder interest as the transferor of all distributions to the donee beneficiaries, the Service instead took the position that the donor should be treated as the transferor of a portion of the property of the CLAT, while the original settlor should continue to be treated as the transferor of the balance. The Service explained the portion theory as follows:

> [T]here will be two transferors with respect to the trust assets in Trust as of the date of the assignment. Child A will be considered the transferor with respect to the portion of the trust assets equal to the present value of the one-sixth remainder interest on the date of the gift. The Decedent will remain the transferor with respect to the balance of the Trust.[113]

As the value of the remainder interest at the time of the child's gift appears to have been small compared to the value of all property of the CLAT, the donor of the remainder interest would be treated as the transferor over only a small fraction of the underlying trust property. Contrary to the taxpayer's proposed analysis, therefore, most of the property ultimately passing to the donees of the remainder interest, *i.e.*, the decedent's grandchildren, would, according the Service's analysis, be subject to GST tax.

B. Inappropriate Results Generated by the Portion Theory

PLR 200107015 addresses the consequences of a gift of a remainder interest in a CLAT. Unfortunately, the Service does not appear to have considered whether the portion theory makes sense in other contexts. Had the Service done so, it may have discovered that the portion theory does not work as a general solution of the GST tax consequences of gifts of beneficial interests.

To illustrate, consider the following facts:

> Example 6: G1 creates a trust under G1's will. The trustee is directed to pay $40,000 annually to each of three beneficiaries, G2a, and G2a's two children, G3a and G3b. Upon G2a's death, the remainder passes to G2b. G2b assigns the remainder interest to another child of G1, G2c. The assignment is effective under local law. The value of the remainder interest

[113] PLR 200107015 (Nov. 14, 2000).

at the time of G2b's gift is equal to 50% of the value of entire trust.

In Example 6, G1 is the original transferor of the trust. Distributions are made annually to skip persons with respect to G1, namely, G3a and G3b. Prior to G2b's gift of the remainder interest, each $40,000 distributed a skip person is a taxable distribution subject to GST tax. At a rate of 40%, the amount of tax due is $16,000.

The initial remainderman, G2b, is not a skip person with respect to G1. Although G2b makes a gift of the remainder interest, the gift is not made to an individual who occupies a lower generation. Rather, the gift is to another non-skip person with respect to G1, namely, G2c. G2b is technically the "transferor" of the remainder interest, but G2b's gift does not cause any property of the trust to pass to lower generations.

Nevertheless, according to the portion theory, G2b's gift has a GST tax consequence. Specifically, because G2b is the transferor of the remainder interest in the trust, G2b should also be treated as the transferor of a portion of the underlying trust property. That portion, according to the theory of PLR 200107015, is equal to the value of the remainder interest at the time of G2b's gift, divided by the value of the entire value of the trust property at the time of the gift. The facts of Example 6 stipulate that this portion equals 50%. Under the portion theory, therefore, G2b becomes the transferor of 50% of the trust property, while G1 remains the transferor of the balance.

G2b's partial displacement of G1 as the transferor of underlying trust property would change the taxation of the $40,000 distributed each year to each of G3a and G3b. Although G1 remains the transferor of 50% of those distributions, G2b becomes the transferor of the balance. G3a and G3b, however, are not skip persons with respect to G2b. Thus, the portion of the distributions of which G2b is considered the transferor is not subject to GST tax. Instead, only $20,000 of each distribution is subject to GST tax, thereby cutting the effective GST tax rate in half.

The result seems inappropriate for at least two reasons. First, G3a and G3b are not in any sense – whether formally or in substance – the recipients of G2b's gift. Rather, G2b made a gift solely to G2c. G3a's and G3b's interests in the trust property are unaffected by G2b's gift: they are entitled an annuity regardless of whether the remainder interest in the trust is assigned or not. Yet, according to the portion theory, G2b should still be treated as the transferor of property passing to G3a and G3b, so that distributions to G3s and G3b become partially shielded from GST tax.

Second, as noted, G2b's gift to G2c does not cause any wealth to pass down a generation. Yet, under the portion theory, G2b's gift acts as an effective shield against GST tax. In other words, according to the portion theory, a gift that has no effect on the interests of other beneficiaries, and does not shift wealth up or down generations, should nonetheless produce GST tax savings.

Recall that, in PLR 200107015, a child of the original transferor proposed to assign the remainder interest down a generation. Application of the portion theory happened to make sense in that case because the property of the underlying CLAT ultimately would pass to the donee of the remainder interest. In many other cases, however, property of a trust will *not* necessarily pass to the same individuals who become substitute, donee beneficiaries of an interest in trust. The Service failed, it seems, to take into account the consequences of the portion theory in such cases.

C. Misidentification of the Property of Which the Donor of a Beneficial Interest is the Transferor

Like the displacement theory, the portion theory appears to be based on a misunderstanding of the property of which the donor of an interest in a trust is the transferor. Consider, once again, the facts of Example 6:

> <u>Example 6</u>: G1 creates a trust under G1's will. The trustee is directed to pay $40,000 annually to each of three beneficiaries, G2a, and G2a's two children, G3a and G3b. Upon G2a's death, the remainder passes to G2b. G2b assigns the remainder interest to another child of G1, G2c. The assignment is effective under local law. The value of the remainder interest at the time of G2b's gift is equal to 50% of the value of entire trust.

Here, G2b makes a gift of the remainder interest in the trust created by G1. Consequently, the remainder interest, as the property the transfer of which is subject to gift tax, is the property of which G2b is the "transferor" for GST tax purposes. The portion theory, however, takes it one step further: under the portion theory, the property of which G2b is the "transferor" also includes a portion of the underlying trust property.

As discussed *supra* in part V.C of this article, however, an individual can be considered the "transferor" of property only if that property was "subject to" gift or estate tax. The Code defines transferor as follows:

> In the case of any property subject to the tax imposed by chapter 11, the decedent, and . . . in the case of any property subject to the tax imposed by chapter 12, the donor.[114]

The definition of "transferor," as discussed *supra* in part V.C of this article, has a *res* requirement: before there can be a transferor for GST tax purposes, there must first be a thing –"property" – that was transferred. Further, the *res* in question must have been "subject to" gift or estate tax.

In Example 6, G2b makes a gift of a remainder interest in the trust created by G1. The assignment of the remainder interest is a transfer subject to gift tax. G2b is, therefore, the transferor for GST tax purposes of the remainder interest. But G2b does not make a transfer of any underlying trust property. To be sure, G2c receives an interest *in* the trust property. Nevertheless, the trust property itself remains titled in the name of the trustee. As G2b literally does not make a transfer of underlying trust property (as opposed to a beneficial interest in the trust property), the trust property is not "subject to" gift tax with respect to G2b. G2b, therefore, cannot be treated as the "transferor" of any portion of the underlying trust property.

Meanwhile, it is easy to identify the individual who was, in fact, subject to gift or estate tax with respect to the underlying trust property: namely, G1, the original settlor of the trust, whose transfer of the trust corpus to the trustee was subject to estate tax under section 2033 of the Code. G2b is merely the individual with respect whom a remainder *interest* in that property was most recently subject to estate or gift tax. G1 is the only individual with respect to whom the trust property itself was subject to gift or estate tax. Thus, contrary to the portion theory, it seems that G1 is the only individual who can be treated as the transferor of the underlying trust property.

In sum, the portion theory erroneously identifies the property of which the donor of a beneficial interest is considered the transferor. The portion theory holds that the donor of a beneficial interest in a trust should be treated as the transferor of a fraction of the property held in the trust. To be treated as the transferor of the property, however, an individual must have made a transfer of property that was "subject to" gift or estate tax. But the donor of a beneficial interest in trust is not subject to gift or estate tax with respect to any underlying trust property. Thus, the donor cannot, it seems, be treated as the transferor of any portion of a trust.

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[114] I.R.C. § 2652(a)(1).

D. Withdrawals of Trust Property versus Assignments of Beneficial Interests

In crafting the portion theory, the Service may have been inspired by a series of private letter rulings that address the gift and GST tax consequences of a *relinquishment* as opposed to an *assignment* of a lead beneficial interest.[115] For gift tax purposes, a relinquishment of a beneficial interest resembles a gratuitous assignment of an interest, in that, in both cases, the individual who relinquishes or assigns the interest (if the relinquishment is not a qualified disclaimer under section 2518 of the Code) is considered to have made a taxable gift of the interest for gift tax purposes. As the gift tax consequences of an assignment of a beneficial interest are often identical to the gift tax consequences of a relinquishment, the Service may have been tempted to analyze the GST tax consequences of each type of taxable gift in the same way.

For example, in PLR 9811044,[116] the trustees of a trust created for the benefit of the settlor's child had discretion to distribute income to the child or that child's descendants, as well as discretion to distribute principal to the child for any worthy purpose. Upon the child's death, the principal was directed to be distributed to the child's surviving issue. The child and the trustees proposed to petition the local court to permit the child to renounce the child's interests, and to terminate the trust in favor of the child's then issue.

The Service held that the income beneficiary's consent to the early termination of his income interest constituted a taxable gift equal to the remaining value of the interest.[117] The value of the gift was a question of fact on which the Service declined to the rule. The Service noted, however, that that child's interest was discretionary and, therefore, could not be valued using standard actuarial factors.

The Service went on in the ruling to consider the GST tax consequences of the income beneficiary's relinquishment of the income interest. According to the Service, the income beneficiary's renunciation of his interest was equivalent to an addition by the income beneficiary to the trust. Under Treas. Reg. § 26.2652-1(a)(5) Example 5, the Service noted, a beneficiary whose general power of appointment has lapsed is deemed to have made an addition to a trust for GST tax purposes, to the

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115 PLR 200243026 (July 24, 2002) (gift of lead interest by exercise of a power of appointment); *see*, *e.g.*, PLR 9707026 (Nov. 19, 1996); PLR 9714030 (Jan. 7, 1997); PLR 200001012 (Sept. 30, 1999); PLR 200210018 (Nov. 28, 2001); PLR 200745015 (June 6, 2007), PLR 200901013 (Sept. 12, 2008) (gifts of lead interests by non-qualified disclaimer); *cf* PLR 201342001 (July 22, 2013) (qualified disclaimer); PLR 9811044 (Dec. 11, 1997); PLR 200745015 (June 6, 2007) (gifts of lead interest by court-ordered termination).

116 PLR 9811044 (Dec. 11, 1997).

117 *Id.*

same extent that the lapse is a gift for gift tax purposes.[118] The Service concluded that, in like manner, an income beneficiary who renounces his interest, and thereby accelerates the remainder beneficiaries' interests, should be treated as having made an addition to the trust for GST tax purposes. Consequently, the income beneficiary, the Service ruled, became the transferor of a portion of the trust property equal to the value of the income interest renounced.

The Service's reasoning in PLR 9811044 is sound. The early termination of a trust by renunciation of the lead interest is indeed equivalent to a withdrawal and addition to the trust. This point can be illustrated by comparing the following two examples:

> Example 7A: A trust created under G1's will requires that all income be paid over to G2 during G2's life. Upon G2's death, the remainder is held in further trust for G3. At a time when the value of the trust corpus is $1 million, G2 renounces G2's income interest in a non-qualified disclaimer that is a taxable gift. A trust of $1 million continues for G3.

> Example 7B: A trust created under G1's will requires that all income be paid over to G2 during G2's life. Upon G2's death, the remainder is held in further trust for G3. The trustee is given the power to prepay or "commute" G2's interest by paying over to G2 an amount equal to the remaining actuarial value of G2's income interest. At a time when the value of the trust corpus is $1 million, the trustee exercises the commutation power by paying over the remaining value of G2's interest to G2. G2 immediately re-contributes the property that G2 receives back to the trust, so that a trust of $1 million continues for G3.

In Example 7B, G2 makes a cash addition directly to the trust for G3, while, in Example 7A, G2 indirectly adds to the trust for G3 by causing G3's interest to be accelerated. The result is the same in both examples: in both, the amount of $1 million is held in further trust for G3. In both cases, in short, G2 makes a gift in trust to G3 of the value of the income interest.

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118 Treas. Reg. § 26.2652-1(a)(5) (ex. 5). Under section 2514(e) of the Code, the lapse of a general power of appointment is considered a release (and, therefore, under section 2514(b) of the Code, a transfer for gift tax purposes) only to the extent that the property that could have been appointed exceeds the greater of $5,000 or 5% of the value of the assets out of which the exercise of the lapsed power could have been satisfied. I.R.C. § 2514(b), (e).

Possibly, in crafting the portion theory in PLR 200107015,[119] the Service was influenced by its reasoning in PLR 9811044.[120] In both rulings, after all, a beneficiary made a taxable gift of his or her beneficial interest. In PLR 9811044, there was a gift of an income interest, and, in PLR 200107015, a gift of a remainder interest. It might seem, therefore, that the GST tax consequences in both rulings should be the same. That is, it might seem that in both cases the former beneficiary should be treated as having made an addition to the trust and therefore should be the "transferor" of a portion of the underlying trust property.

Yet the comparison between the relinquishment of an interest, such as in PLR 9811044, and an assignment an interest, such as in PLR 200107015, is misleading. The distinction between the two can be illustrated by comparing the following two examples:

> <u>Example 8A</u>: A trust created under G1's will requires $5,000 a year to be paid annually to G2a for G2a's life. Upon G2a's death, the remainder is held in trust for G3. G2a renounces the annuity interest in a non-qualified disclaimer.
>
> <u>Example 8B</u>: A trust created under G1's will requires $5,000 a year to be paid annually to G2a for G2a's life. Upon G2a's death, the remainder is held in trust for G3. G2a assigns the annuity interest to G2b. The assignment is effective under local law.

In both examples, G2a makes a gift of a $5,000-a-year annuity interest. In Example 8A, the gift causes G3's remainder interest to be accelerated. The value of G3's remainder interest is increased, just as if the present value of G2a's annuity had been prepaid to G2a and G2a had immediately re-contributed the prepayment to the ongoing trust for G3. Thus, it makes sense to treat G2a as having made a constructive addition to the trust for G3.

In Example 8B, by contrast, the value of G3's remainder interest is unaffected by G2a's gift. Instead, the annuity is shifted to another non-skip person with respect to G1, namely, G2b. If G2a is treated as having made a constructive addition to the trust, then a portion of the remainder ultimately passing to the trust for G3 would be shielded from GST tax, even though G2a did not actually add to the value of G3's remainder interest. Consequently, it does not make sense to view G2a as having made a constructive addition to the trust.

As Examples 8A and 8B show, the assignment of a beneficial interest should not be treated in the same way as a relinquishment of a bene-

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119 PLR 200107015 (Nov. 14, 2000).

120 PLR 9811044 (Dec, 11, 1997).

ficial interest.[121] In particular, an assignment of a beneficial interest should not be treated as a constructive addition akin to a withdrawal and re-contribution of trust property. Thus, the rulings treating the early termination of a trust by relinquishment of a lead beneficial interest should not be viewed as support for the portion theory.

E. The Portion Theory and Treasury Regulations

In addition to leading to inappropriate results and misidentifying the property of which the donor of a beneficial interest is the transferor, the portion theory appears to be precluded by Treasury regulations. The relevant regulations are discussed *infra* in parts VII.C-E of this article.

F. Conclusion

The portion theory was devised as an alternative to the displacement theory, which the taxpayers have advocated in the case of a gift of a remainder interest in a CLAT. Unfortunately, while the portion theory might have made sense in the CLAT context, it does not make sense in other situations. Furthermore, the displacement theory is technically unsound. The Service's portion theory has only added to the confusion in an already highly perplexing area.

VII. Treasury Regulations on the Dueling Transferors Problem

Thus far, our discussion of the dueling transferors problem has focused on policy considerations, judicial tax doctrines, fundamental tax principles, and a close reading of the definitions set forth in the Code and Treasury regulations. In addition to these authorities, there is an example in Treasury regulations that directly addresses the dueling transferors problem. As we will see, the example is difficult to reconcile with either the displacement theory or the portion theory.

A. Treas. Reg. § 26.2652-1(a)(5) Example 4

Example 4 of Treas. Reg. § 26.2652-1(a)(5) provides as follows:

> *Effect of transfer of an interest in trust on identity of the transferor*. T transfers $100,000 to a trust providing that all of the net income is to be paid to T's child, C, for C's lifetime. At C's death, the trust property is to be paid to T's grandchild. C transfers the income interest to X, an unrelated party, in a

[121] *Cf.* I.R.C. § 2514(e) (treating certain lapses of general powers of appointment as transfers of property by gift for gift tax purposes).

> transfer that is a completed transfer for Federal gift tax purposes. Because C's transfer is a transfer of a term interest in the trust that does not affect the rights of other parties with respect to the trust property, T remains the transferor with respect to the trust.[122]

Unfortunately, the foregoing regulation is susceptible to various different interpretations. For now, it is worth noting two important aspects of the example.

First, Treas. Reg. § 26.2652-1(a)(5) Example 4 clearly poses a dueling transferors problem. The settlor of the trust in the example, T, makes an initial gift of $100,000. Thus, T is the initial transferor of the trust corpus. Later, the initial income beneficiary, C, makes a gift of the income interest. Although the example does not say so explicitly, C should presumably be treated as the transferor of the income interest. Thus, the two gifts give rise to "dueling" transferors: that is, it is not obvious (at least not at first) whether T, as the transferor of the trust, or C, as the transferor of the income interest, should be treated as the transferor for purposes of determining whether distributions from the trust are subject to GST tax.

Second, the example seems intended to provide taxpayers guidance as to how the dueling transferors problem should, at least in some circumstances, be resolved. The example's conclusion – "T remains the transferor with respect to the trust" – directly addresses the identity of the transferor following a gift of a beneficial interest. That the example is designed to resolve the dueling transferors problem is underscored by the example's heading, which promises that the example will explain the "[e]ffect of transfer of an interest in trust on identity of the transferor." Treas. Reg. § 26.2652-1(a)(5) Example 4 remains to this day the only binding authority to address the dueling transferors problem directly.

B. Ambiguities and Uncertainties of Treas. Reg. § 26.2652-1(a)(5) Example 4

Unfortunately, for all that Treas. Reg. § 26.2652-1(a)(5) Example 4 remains the only binding authority to address the dueling transferors problem, it is not very well crafted. In particular, it leaves the following questions unaddressed:

> 1. GST tax at C's death. Perhaps the most obvious implication of Treas. Reg. § 26.2652-1(a)(5) Example 4's conclusion that "T remains the transferor" is that the eventual passing of the trust to T's grandchild will be subject to GST tax. For example, assuming that

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122 Treas. Reg. § 26.2652-1(a)(5) (ex.4).

a taxable termination does not occur earlier,[123] the termination of the trust at C's death in favor of T's grandchild should be considered a taxable termination. However, the example does not confirm that conclusion.

2. GST tax on C's gift. The example does not specify the generation assignment of X, the donee of the income interest. If X is a skip person with respect to C, then C's gift would presumably be a direct skip subject to GST tax. Once again, the example does not confirm that conclusion.

3. Significance of X's status as an "unrelated party." The example states that X is an "unrelated party." It is unclear how X's relationship to T or C, apart from X's generation assignment, would affect the gift or GST tax consequences of C's gift. The significance of the fact that X is an "unrelated party" is a mystery.

4. Taxable termination upon C's gift. After C's gift, the only person with an interest in the trust for GST tax purposes is X. As noted, the example does not specify X's generation assignment. If X were a skip person with respect to T, however, then the example's conclusion – that "T remains the transferor with respect to the trust" – would imply that C's gift triggers a taxable termination subject to GST tax, as the only individual with an interest in the trust for GST tax purposes would then be X.[124] On the other hand, if the displacement theory is true, then it seems that a taxable termination would not occur upon C's gift, even if X is a skip person with respect to T.[125]

5. Significance of the example's rationale. The example provides not only a conclusion – that "T remains the transferor with respect

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123 Suppose that X, the donee of C's income interest, is a skip person with respect to T. In that case, it is possible that C's gift triggers a taxable termination, as, upon C's gift, the only individual with an interest in the property held in trust would be a skip person with respect to T.

124 Alternatively, it is possible that a mere transfer of an interest is not a "termination" within the meaning of section 2612(a)(1) of the Code. In this view, when an interest in a trust is assigned, it does not "terminate" but merely continues for another beneficiary. If that is the case, however, then it is unclear whether distributions from the trust to X would be taxable distributions subject to GST tax.

125 Suppose that X is treated as the income beneficiary for GST tax purposes after C's gift, so that a taxable termination is triggered by C's gift. That result is contrary to the displacement theory's premise that an assignment of a beneficial interest down a generation should not be subject to GST tax. To avoid that result, as discussed *infra* in the text, the displacement theory would deem C to be the income beneficiary even after C assigns the income interest to X. In this manner, as C is not a skip person with respect to T, the displacement theory could conclude that no taxable termination occurs upon C's gift, regardless of X's generation assignment.

> to the trust" – but also a rationale for that conclusion, namely, that "C's transfer is a transfer of a term interest in the trust that does not affect the rights of other parties with respect to the trust property." The rationale points to two features of C's gift that could be viewed as explaining the example's conclusion: that C's gift is a gift of a "term interest," and that C's gift "does not affect the rights of other parties with respect to the trust property." It is unclear whether the example's conclusion would be different in the case of a gift of an interest other than a "term interest" and/or a gift that does "affect the rights of other parties with respect to the trust property."

As a result of the foregoing uncertainties, Treas. Reg. § 26.2652-1(a)(5) Example 4 is not as helpful as it should be in resolving the dueling transferors problem. Resolution of the problem must rely primarily, as in this article, on fundamental tax principles. Nevertheless, for all of the example's failings, it does provide some guidance. At a minimum, as we shall see, it is difficult to reconcile the example with either the portion theory or the displacement theory.

C. Treas. Reg. § 26.2652-1(a)(5) Example 4 and the Portion Theory

The portion theory holds that, upon a gift of a beneficial interest, the donor of the interest should be treated as the transferor of a fraction of the underlying trust property. In Treas. Reg. § 26.2652-1(a)(5) Example 4, T creates a trust for the benefit of C. C then makes a gift of the income interest to another individual. According to the portion theory, T and C would, as a result of C's gift, become transferors of separate fractions of the underlying trust property. That is, C, as the donor of the income interest, would become the transferor of a portion equal to the value of the income interest at the time of C's gift, divided by the value of the entire trust, while T would remain the transferor of the balance.

Yet Treas. Reg. § 26.2652-1(a)(5) Example 4 concludes that T, the initial settlor, "remains the transferor with respect to the trust."[126] There is no mention of C, the donor of the income interest, becoming the transferor of any of the trust property. Thus, it seems that the example's conclusion contradicts the central assertion of the portion theory, namely, that the donor of a beneficial interest should be treated as the transferor of a fraction of underlying trust property.

Further, the example's rejection of the portion theory follows naturally from the definition of "transferor." Under that definition, as discussed *supra* in part VI.C of this article, for an individual to be considered the "transferor" of property for GST tax purposes, the indi-

[126] Treas. Reg. § 26.2652-1(a)(5) (ex. 4).

vidual must have made a transfer of the property that was "subject to" gift or estate tax.[127] When C, the initial income beneficiary in Treas. Reg. § 26.2652-1(a)(5) Example 4, makes a gift of the income interest, the property "subject" to gift tax is the income interest in the trust property. C does not transfer and is not subject to gift tax with respect to any of the underlying trust property (as opposed to a beneficial interest in the underlying trust property). Thus, contrary to the portion theory, it seems that C does not meet the definition of "transferor" with respect to any of the trust.

Nor would it make sense, as a policy matter, to treat the donor of an income interest as the transferor of underlying trust property. C's gift in Treas. Reg. § 26.2652-1(a)(5) Example 4 does not cause any wealth to shift to the remainder beneficiary, who is a grandchild of the settlor. Yet, if the portion theory were correct, C would become the transferor of a portion of the underlying trust property. As a result, C's gift, under the portion theory, would effectively shield from GST tax a portion of the trust property passing to T's grandchild. But as C did not actually make any gift to the settlor's grandchild, it would not make sense for C's gift to have the effect of reducing GST tax. Thus, contrary to the portion theory, C should not be treated as the transferor of any of the underlying trust property.

Finally, the example's rationale is consistent with the conclusion that C's gift of the income interest does not, contrary to the portion theory, make C the transferor of any of the underlying trust property. Treas. Reg. § 26.2652-1(a)(5) Example 4 states that the reason that the original settlor the remains the transferor of the trust is that "C's transfer is a transfer of a term interest in the trust *that does not affect the rights of other parties with respect to the trust property*."[128] The italicized portion of the rationale correctly notes that C's gift does not affect the remainderman's interest in the trust. That is, the settlor's grandchild will receive all of the principal of the trust upon C's death regardless of whether C makes a gift of the income interest or not. Given that C's gift has no effect on the grandchild's interest, it would not make sense for C's gift to cause a change in the transferors of the underlying trust property. Rather, the original settlor should continue be treated as the transferor.

In short, Treas. Reg. § 26.2652-1(a)(5) Example 4 is strong authority contrary to the portion theory.[129] To be sure, as discussed below, it

127 *See supra* Part VI.C.

128 Treas. Reg. § 26.2652-1(a)(5) (ex. 4) (emphasis added).

129 Treas. Reg. § 26.2601-1(b)(4)(E) Example 7, like Treas. Reg. § 26.2652-1(a)(5) Example 4, involves a gift, by a court-ordered modification of the terms of a trust, of an income interest from one beneficiary to another. There is no suggestion in Treas. Reg.

might be possible to distinguish the example in some cases, or to construe it in a way that is somehow consistent with the portion theory. At least at first, however, the example seems designed to reject the portion theory.

D. Treas. Reg. § 26.2652-1(a)(5) Example 4 and PLR 200107015

If Treas. Reg. § 26.2652-1(a)(5) Example 4 rejects the portion theory, why has the Service embraced the theory in private letter rulings? In PLR 200107015,[130] for example, the Service took the position that a gift of a remainder interest in a CLAT causes the donor of the interest to become the transferor of a portion of the underlying trust property. Yet Treas. Reg. § 26.2652-1(a)(5) Example 4 holds that a gift of a beneficial interest does not cause a change of the transferors of the trust. It is unclear why the Service embraced the portion theory despite the apparent contrary authority in Treasury regulations.

Perhaps the Service simply overlooked Treas. Reg. § 26.2652-1(a)(5) Example 4. The regulation was not analyzed, distinguished or even cited in PLR 200107015. Indeed, the regulation has not apparently been cited by the Service in *any* rulings to date. Despite being the only binding authority to address the dueling transferors problem directly, Treas. Reg. § 26.2652-1(a)(5) Example 4 seems to have been simply ignored.

Another explanation, besides carelessness, for the Service's failure to analyze Treas. Reg. § 26.2652-1(a)(5) Example 4 is that the Service may have viewed the example as irrelevant. In PLR 200107015, a child of the settlor made a gift of his remainder interest in a CLAT to a grandchild of the settlor.[131] In Treas. Reg. § 26.2652-1(a)(5) Example 4, by contrast, an income beneficiary made a gift of the income interest in a trust. Possibly, the Service believed that the regulation was not applicable to a gift of a remainder interest, as opposed to a gift of a lead interest.

The text of Treas. Reg. § 26.2652-1(a)(5) Example 4 might be viewed as providing some support for the view that the regulation does not apply to gifts of remainder interests. As discussed, the example explains that the original settlor, T, remains the transferor, despite that the settlor's child, C, makes a gift of the income interest, because C's gift is "a transfer of a term interest in the trust that does not affect the rights of

§ 26.2601-1(b)(4)(E) Example 7 that a change of transferors occurs; indeed, the regulation seems to assume that there is no change of transferors of the underlying trust property. Thus, like Treas. Reg. § 26.2652-1(a)(5) Example 4, Treas. Reg. § 26.2601-1(b)(4)(E) Example 7 appears to be inconsistent with the portion theory.

130 PLR 200107015 (Nov. 14, 2000).

131 *See id.*

other parties with respect to the trust property."[132] If the reason that the identity of the transferor does not change upon a gift of an income interest is that an income interest is merely a "term interest," then, perhaps, the identity of the transferor *can* change upon a gift of a *remainder* interest.[133]

The view that Treas. Reg. § 26.2652-1(a)(5) Example 4 applies solely to gifts of "term interests," however, is not persuasive. For one thing, the example's rationale is not merely that C makes a gift of a "term interest." Rather, it is that C makes a gift of a term interest "that does not affect the rights of other parties with respect to the trust property." One way of understanding this rationale is that a gift of a beneficial interest does not normally cause a shift of wealth to any of the other beneficiaries of the trust. In Treas. Reg. § 26.2652-1(a)(5) Example 4, for example, the remainderman will become entitled to principal upon C's death regardless of the whether the income interest is assigned to another or not.[134] Likewise, in the case of a gift of a remainder interest, the lead beneficiaries will typically receive whatever income or principal they are entitled to, regardless of whether the remainder interest is assigned to another or not. In general, therefore, a gift of a beneficial interest, whether of a lead or a remainder interest, should not change the identity of the transferor of the underlying trust property. The rationale of Treas. Reg. § 26.2652-1(a)(5) Example 4, despite its reference to "term interest," seems to apply just as much to gifts of remainder interests as to gifts of term interests.

Moreover, the portion theory suffers from the same basic technical flaw, regardless of whether the gift in question is a gift of a lead or a remainder interest: namely, that the donor of a beneficial interest does not actually make a gift of any underlying trust property (as opposed to a beneficial interest in that property). As discussed, an individual can only be treated as the "transferor" of property with respect to which he or she is "subject to" gift or estate tax. As the property that is "subject to" gift tax when a beneficiary assigns his or her interest to another is a

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[132] Treas. Reg. § 26.2652-1(a)(5) (ex. 4).

[133] The heading of the example might suggest additional support for the distinction between gifts of "term interests" and remainder interests. The heading promises that the example will explain the "[e]ffect of transfer of an interest in trust on identity of the transferor." The term "interest in trust" might be an allusion to the technical definition in section 2652(c) of the Code of "interest in property held in trust," which, in the case of individuals, generally excludes remainder interests. On the other hand, the heading's language fails to track precisely the defined term, "interest in property held in trust."

[134] Of course, it is possible to imagine situations where an assignment of a beneficial interest does affect the rights of other parties. For example, the settlor could have provided that if one beneficiary assigns his or her interest to another, then another beneficiary's interest is thereby cut down or eliminated.

beneficial interest in the property rather than the underlying trust property itself, the donor of a beneficial interest, regardless of whether the interest is a term interest or a remainder interest, should not be treated as the "transferor" of any portion of the underlying trust property. Treas. Reg. § 26.2652-1(a)(5) Example 4 is perhaps best read as confirming this application of the definition of "transferor."

Finally, there does not appear to be any policy rationale for treating an assignment of a lead interest differently from an assignment of a remainder interest. In both cases, treating the donor as the transferor of a portion of underlying trust property can lead to inappropriate results. Consider, once again, the following hypothetical discussed *supra* in parts VI.B-C of this article:

> Example 6: G1 creates a trust under G1's will. The trustee is directed to pay $40,000 annually to each of three individuals, G2a and G2a's two children, G3a and G3b. Upon G2a's death, the remainder passes to G2b. G2b assigns the remainder interest to another child of G1, G2c. The assignment is effective under local law. The value of the remainder interest at the time of G2b's gift is equal to 50% of the value of entire trust.

Here, if G2b is treated as the transferor of underlying trust property, then taxable distributions to G3a and G3b will be partially shielded from GST tax, even though G2b does not cause any wealth to shift to G3a or G3b. In like fashion, if the donor of the income interest in Treas. Reg. § 26.2652-1(a)(5) Example 4 were treated as the transferor of underlying trust property, then the property passing to the skip person remainderman would be partially shielded from GST tax, even though the donor does not cause any wealth to shift to the remainder beneficiary. Neither result makes sense as a policy matter, and, in part for that reason, both results should be seen as foreclosed by Treas. Reg. § 26.2652-1(a)(5) Example 4 and the background principles that the regulation illustrates.

In any event, whatever the Service's reasons for failing to cite Treas. Reg. § 26.2652-1(a)(5) Example 4, the regulation cannot be ignored. Any viable resolution of the dueling transferors problem must, at minimum, not be directly inconsistent with the regulation. The portion theory, at least with respect to gifts of term interests, and perhaps also with respect to gifts of remainder interests, fails to satisfy that criterion.

E. Treas. Reg. § 26.2652-1(a)(5) Example 4 and the Displacement Theory

Treas. Reg. § 26.2652-1(a)(5) Example 4 also poses difficulties for any defense of the displacement theory. Once again, the facts of the example are as follows:

> T transfers $100,000 to a trust providing that all of the net income is to be paid to T's child, C, for C's lifetime. At C's death, the trust property is to be paid to T's grandchild. C transfers the income interest to X, an unrelated party, in a transfer that is a completed transfer for Federal gift tax purposes.[135]

Unfortunately, the facts do not specify X's generation assignment. Suppose, however, that X is a skip person with respect to T. Upon C's gift to X, C's interest in the trust would terminate. X would thereafter be the only individual with an "interest in property held in trust" within the meaning of section 2652(c) of the Code. Consequently, it would seem that C's gift would trigger a taxable termination within the meaning of section 2612(a) of the Code.[136]

But the conclusion that a GST tax is triggered by C's gift is inconsistent with the displacement theory. To see why, suppose that the facts of Treas. Reg. § 26.2652-1(a)(5) Example 4 were modified as follows:

> T transfers $100,000 to a trust providing that all of the net income is to be paid to T's child, C, for C's lifetime. At C's death, the trust property is to be paid to T's grandchild. C transfers *90% of* the income interest to X, an unrelated party, in a transfer that is a completed transfer for Federal gift tax purposes.

The only difference between the foregoing facts and the facts of Treas. Reg. § 26.2652-1(a)(5) Example 4 is that, in Treas. Reg. § 26.2652-1(a)(5) Example 4, C makes a gift of the entire income interest, whereas, in the foregoing facts, C makes a gift of the right to 90% of the income. In the latter case, the displacement theory holds that C should be treated as the transferor of any income distributed to X. Thus, if C makes a gift of a 90% income interest, then, even if X is a skip person with respect to T, X should not, according to the displacement theory, be subject to GST tax on the income paid over to X.

Presumably, the result should not be different if, as in Treas. Reg. § 26.2652-1(a)(5) Example 4, X receives a gift of the entire income interest. But if X is a skip person with respect to T and, in consequence, a taxable termination occurs upon C's gift of the entire income interest to X, then X's interest in the trust would effectively be cut down by a GST

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135 Treas. Reg. § 26.2652-1(a)(5) (ex. 4).

136 An alternative view, which does not affect the analysis in the text, is that a mere transfer of an interest is not a "termination" within the meaning of section 2612(a)(1). In this view, when an interest in a trust is assigned, it does not "terminate" but merely continues for another beneficiary. If that is the case, then, unless the displacement theory is correct, distributions from the trust to X would be taxable distributions subject to GST tax.

tax imposed on the trust. In other words, if a taxable termination occurs, X would bear the burden of GST tax imposed on the trust, even though, according to the displacement theory, no GST tax should be imposed if C transfers merely a portion of the income interest. At least for the sake of consistency, therefore, it seems that the displacement theory would conclude a taxable termination does not occur after all. That is, just as the displacement theory concludes that X is not subject to GST tax on income distributions if C makes a gift of a fraction of the income interest, the displacement theory would likewise conclude that a taxable termination does not occur if C makes a gift of the entire income interest.

Fortunately, to explain why a taxable termination does not occur, the displacement theory need only appeal to the same analysis that it employs in other cases. That is, as discussed in detail *supra* in part V.A of this article, the displacement theory would, once again, view each distribution from a trust to a donee beneficiary to consist of two separate transfers: first, as a transfer from the trustee to the former, donor beneficiary, and, second, as a transfer from the former beneficiary to the new, donee beneficiary. In other words, the displacement theory, in effect, would treat the former, donor beneficiary as continuing to hold the beneficial interest while paying over all distributions to the new, donee beneficiary. By treating the donor beneficiary in this manner, the displacement theory is able to avoid the conclusion that a taxable termination can be triggered by the assignment of a beneficial interest.

In the Treas. Reg. § 26.2652-1(a)(5) Example 4 situation, X would be deemed, according to the displacement theory, to receive X's income distributions from C. Meanwhile, C would continue to be deemed to be the income beneficiary of the trust. Thus, no taxable termination could occur upon C's gift, as C, a non-skip person, would continue to be treated as having an interest in the trust for GST tax purposes. In this manner, the displacement theory would prevent C's gift to X from being subject to GST tax.

But the foregoing analysis of the facts in the Treas. Reg. § 26.2652-1(a)(5) Example 4 has an apparently fatal flaw, namely, that it is at odds with the definition of "interest in property held in trust." Treas. Reg. 26.2612-1(e)(1) provides that an individual has "an interest in trust" if he or she "[h]as a present right to receive trust principal or income" or "[i]s a permissible current recipient of trust principal or income."[137] This rule appears to be very much "reality-based," as it were. That is, it does not appear to permit an individual who is not actually eligible or

137 Treas. Reg. § 26.2612-1(e)(2).

entitled to receive income or principal nevertheless to be *deemed* have an interest in trust.

In the situation presented by Treas. Reg. § 26.2652-1(a)(5) Example 4, for example, C fully divests himself of the income interest in the trust created by T. Following C's gift, in other words, C is no longer eligible or entitled to receive income (or principal). X, meanwhile, does become entitled to the income of the trust. Contrary to the displacement theory, therefore, under Treas. Reg. 26.2612-1(e)(1), X has an "interest in trust," while, it seems, C does not. If X is a skip person with respect to T, therefore, a taxable termination should occur upon C's gift to X, as C will not be treated as continuing to have an interest in the trust. The displacement theory would reach the opposite conclusion based on a fiction – that C continues to have an interest in property held in trust – that the Code and Treasury regulations do not support.

The exceptions to the general rule of Treas. Reg. 26.2612-1(e) reinforce the conclusion that a former beneficiary cannot be deemed to continue to have an interest in property held in trust. Under these exceptions, three types of beneficial interests will be deemed *not* to be "interests in trust" for GST tax purposes: namely, (i) the ability to have support obligations satisfied by discretionary distributions, (ii) interests "used primarily to postpone or avoid the GST tax," and (iii) interests that are disclaimed by qualified disclaimer described in section 2518 of the Code.[138] These three exceptions apply only to *disregard* certain beneficial interests. There is no rule in the Code or Treasury regulations whereby a beneficial interest that does *not* exist for state law purposes is *deemed* to exist for GST tax purposes.

Yet, as we have seen, the displacement theory appears to rest on the fiction that a former beneficiary who assigned his or her beneficial interest to another should be deemed to continue to have an interest in the trust property for GST tax purposes. But there is no such deeming rule in either the general or the regulatory exceptions: the only individuals who are considered to have trust interests for GST tax purposes are those who are actually eligible or entitled to receive income or principal. By negative inference from the three exceptions to the definition of "interest in trust," it would seem that the displacement theory's treatment of the former beneficiary as nevertheless having an "interest in trust" is foreclosed by the GST tax regulations.

Further, the policy underlying the second exception is at odds with the displacement theory. Under that exception, an interest "used primarily to postpone or avoid the GST tax"[139] is disregarded. The excep-

[138] *Id.*
[139] Treas. Reg. § 26.2612-1(e)(2)(ii).

tion goes on to state that an interest is used primarily to postpone or avoid the GST tax "if a significant purpose for the creation of the interest is to postpone or avoid GST tax."[140] Strictly speaking, this exception does not forbid the use of proposed *fictional* interests to avoid GST tax, such as the fictional interests proposed by the displacement theory. Nevertheless, if *actual* interests can be disregarded if their purpose is to postpone or avoid GST tax, then *a fortiori* proposed *fictional* interests should likewise be rejected. In short, the displacement theory appears to be inconsistent with the general definition of "interest in trust," the exceptions, and the policy behind those exceptions.

To be sure, to return to Treas. Reg. § 26.2652-1(a)(5) Example 4, defenders of the displacement theory might argue that the regulation is not, strictly speaking, inconsistent with the displacement theory. The conclusion of the example is merely that the original settlor, T, "remains the transferor with respect to the trust." The regulation says nothing about whether C should be deemed to remain the beneficiary.

In light of the Code's definition of "interest in property held in trust," however, it seems unlikely that the Treas. Reg. § 26.2652-1(a)(5) Example 4's silence as to whether C or X should be treated as the beneficiary of the trust for GST tax purposes would be resolved in favor of the displacement theory. As discussed, an individual can only be considered to have an interest in property held in trust for GST tax purposes if he or she is actually eligible or entitled to receive income or principal. If there were a hidden exception to this rule that permitted a former, donor beneficiary to be treated as continuing to have an interest in trust, Treas. Reg. § 26.2652-1(a)(5) Example 4 would have afforded the Service an opportunity to say so. That the example does not indicate that C, the former income beneficiary, should continue to be treated as the beneficiary for GST tax purposes, likely means that a former, donor beneficiary cannot, contrary to the displacement theory, be treated as having an interest in property held in trust. Treasury regulations, in short, appear to pose a formidable obstacle to any defense of the displacement theory.

VIII. The No Effect Theory

Neither the displacement theory nor the portion theory appears to be a tenable solution to the dueling transferors problem. Perhaps the remaining theory – the no effect theory – should prevail simply by process of elimination. In any event, as discussed in this section, the no effect theory, in contrast to the two rival theories, follows from the Code's definition of "transferor" and is supported by the one regulation

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[140] *Id.*

to address the dueling transferors problem. In addition, the no effect theory is indirectly supported by prior case law in the gift and estate tax area.

A. The No Effect Theory and the Definition of "Transferor"

The no effect theory follows from a straightforward reading of the Code's definition of "transferor." That definition is as follows:

> In the case of any property subject to the tax imposed by chapter 11, the decedent, and . . . in the case of any property subject to the tax imposed by chapter 12, the donor.[141]

Treasury regulations similarly provide that the transferor is "the individual with respect to whom property was most recently subject to Federal estate or gift tax."[142] In other words, in order to be the "transferor" of property for GST tax purposes, an individual must have made a transfer of that property that was subject to gift or estate tax.

In at least one respect, the application of the definition of "transferor" to a gift of a beneficial interest is uncontroversial: If an individual irrevocably assigns a beneficial interest in a trust to another, and the assignment is a transfer by gift for gift tax purposes, then the donor of the interest is also the transferor of that interest for GST tax purposes. Thus, as all three proposed solutions to the dueling transferors – *i.e.*, the no effect theory, the portion theory, and the displacement theory – would agree, if a beneficial interest is assigned to a grandchild of the assignor, the assignment would be a direct skip subject to GST tax.[143]

The controversy over the GST tax consequences of a gift of beneficial interest only arises because it is unclear, at least at first, whether the donor should be considered the "transferor" of any property *other* than the beneficial interest. According to the portion theory, the donor of a beneficial interest in a trust should also be treated as the transferor of a fraction of the corpus of the trust. According to the displacement theory, the donor of a beneficial interest should also be treated as the transferor of any subsequent distributions from the trust to the substitute, donee beneficiary. Both theories assume that the donor of a beneficial interest can be treated as the transferor of property other than the property that the donor actually transferred.

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141 I.R.C. § 2652(a)(1).

142 Treas. Reg. § 26.2652-1(a)(1).

143 It would also follow, according to the no effect theory, that distributions to the donee beneficiary would be subject to GST tax. This result, while harsh, is no more harsh, as discussed *infra* in the text, than other consequences of the gift and estate tax system.

The no effect theory, by contrast, refrains from drawing any further inferences regarding the property with respect to which the donor of the beneficial interest should be considered the transferor. The theory's analysis can be illustrated using the first example introduced in this article:

> Example 1: G1 creates a trust under G1's will whose net income is directed to be paid annually to G2a. Upon G2a's death, the remainder is payable to G2b or G2b's estate. G2b irrevocably assigns G2b's remainder interest to G3 for no consideration. The assignment is effective under local law.

In Example 1, G2b does not make a gift of the underlying property of the trust. Rather, G2b makes a gift of a beneficial interest *in* trust corpus. To put it another way, G3 receives from G2b a "bundle of rights" with respect to trust property, including the right, ultimately, to compel distribution of principal upon G2a's death.[144] The trust property itself, meanwhile, remains in the hands of the trustee.

The no effect theory reasons that G2b should be treated as the transferor of the "bundle of rights" that G2b assigns to G3. But as an individual cannot be considered the "transferor" of property with respect to which he or she does not actually make a transfer that is subject to gift or estate tax, G2b should not be considered the "transferor" of the underlying trust property itself (as opposed to a beneficial interest in that property). Nor should G2b be considered the transferor of the "fruits" of the beneficial interest, namely, any subsequent distributions to G3. Instead, G1, as the individual who made the initial transfer of trust corpus, should remain the transferor of the trust property, including distributions.

The portion theory and the displacement theory are more audacious in their reasoning. The portion theory holds that G2b should be treated as the transferor of a fraction of the trust property, even though G2b did not actually make any transfer of any of the underlying trust property (as opposed to a beneficial interest in the trust property). The displacement theory holds that G2b should be treated as the transferor of all property paid over by the trustee to G3, even though G2b does not make an actual transfer of any of that property.[145] To reach those conclusions, the portion theory and the displacement theory rely, by neces-

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[144] *Cf.* United States v. Craft, 535 U.S. 274, 278 (2002) ("A common idiom describes property as a 'bundle of sticks'").

[145] The displacement theory creates some interesting technical difficulties. Suppose, for example, that in Example 1 the trustee erroneously computes income, under-distributes to G2a and thereby causes more principal to pass to G3 than G3 should be entitled to. Should the entire over-distribution to G3 be protected against GST tax, or merely the portion that should have been distributed?

sity, on extra-statutory reasoning. Thus, the displacement theory, as discussed *supra* in part V of this article, appeals to the notion that substance should prevail over form, while the portion theory, as discussed *supra* in part VI of this article, extends by analogy the consequences of a renunciation of a beneficial interest to the case of an assignment of a beneficial interest.

Whatever the merits of the extra-statutory reasoning behind displacement theory and the portion theory, neither readily follows from the Code's definition of "transferor." To be treated as the "transferor" of property for GST tax purposes, an individual must have made a "transfer" of that property that was "subject to" gift or estate tax. Where an individual makes a gift of a beneficial interest, the "property" that he or she transfers is the beneficial interest. He or she does not, it seems, make a transfer that is subject to gift or estate tax of a portion of the underlying trust property (as opposed to a beneficial interest in the trust property) or of the "fruits" of the beneficial interest, namely, any distributions made to the donee beneficiary. Yet the portion theory assumes that the donor of a beneficial interest can be treated for GST tax purposes as the "transferor" of underlying trust property, while the displacement theory assumes that he or she can be treated as the "transferor" for GST tax purposes of subsequent distributions. Both theories, as discussed in further detail *supra* in parts V and VI of this article, appear to go beyond the warrant of the statutory text. Under the Code's definition of "transferor," an individual is only treated as the transferor of property that he or she actually transferred in a transfer subject to gift or estate tax.

The no effect theory, in sum, is the solution to the dueling transferors problem that has the most respect for the actual language of the Code. Many may feel strongly that, whatever the Code may say, an individual who makes a gift of a beneficial interest *should*, as the displacement theory holds, be treated as the transferor of subsequent distributions. But the language of the Code does not support the inference that an individual can be treated as the transferor of property other than that which he or she has actually transferred. In the case of a gift of a beneficial interest, the only conclusion supported by the Code is that the donor is the transferor for GST tax purposes of the beneficial interest. That, and no other, is the conclusion that the no effect theory reaches.

B. Treas. Reg. § 26.2652-1(a)(5) Example 4 and the No Effect Theory

As discussed in detail *supra* in part VII.A of this article, there is only one binding authority that directly addresses the dueling transferor problem, namely, Treas. Reg. § 26.2652-1(a)(5) Example 4. The facts of the example are as follows:

> T transfers $100,000 to a trust providing that all of the net income is to be paid to T's child, C, for C's lifetime. At C's death, the trust property is to be paid to T's grandchild. C transfers the income interest to X, an unrelated party, in a transfer that is a completed transfer for Federal gift tax purposes.

Here, the initial income beneficiary, C, makes a gift of the income interest to another individual, X. C's gift of the income interest should cause to C to become the transferor of the income interest for GST tax purposes. Thus, although the regulation does not confirm this conclusion, it seems that, if X were a skip person with respect to C, C's gift would be a direct skip subject to GST tax. None of the three solutions to the dueling transferors problem – the portion theory, the displacement theory, and the no effect theory – would disagree.

The three solutions differ only on the question of whether C should *also* be treated as the transferor of any of the underlying trust property. The no effect theory answers the question in the negative. That is, according to the no effect theory, C would not, as the portion theory would hold, become the transferor of any portion of the underlying trust property. Nor would C, as the displacement theory would hold, become the transferor of any income earned on the underlying trust property and subsequently distributed to X. Rather, according to the no effect theory, T should continue to be treated as the transferor of the property held in the trust, both at the time of C's gift and when income from the trust is distributed to X.

That T, as the no effect theory holds, remains the transferor of the trust, despite C's gift of the income interest, is precisely what Treas. Reg. § 26.2652-1(a)(5) Example 4 provides. As the example concludes, the original settlor, T, "remains the transferor with respect to the trust."[146] Furthermore, the example's conclusion appears to follow, as the no effect theory would argue, from the general definition of the "transferor." The "transferor" of property for GST tax purposes is "the individual with respect to whom property was most recently subject to estate or gift tax."[147] In Treas. Reg. § 26.2652-1(a)(5) Example 4, C at no point makes a gift of any property *other* than the income interest in the trust. In particular, at no point does C make a gift of underlying trust property (as opposed to an income interest in trust property). Therefore, according to the no effect theory, C should not be treated as the transferor of the trust. Treas. Reg. § 26.2652-1(a)(5) Example 4 apparently adopts

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146 Treas. Reg. § 26.2652-1(a)(5) (ex. 4).
147 Treas. Reg. § 26.2652-1(a)(1).

that very line of reasoning: T, the example concludes, rather than C, continues to be the "transferor" of the trust. In short, the regulation supports both the reasoning and the conclusion of the no effect theory.

To be sure, as discussed in detail *supra* in part VII of this article, Treas. Reg. § 26.2652-1(a)(5) Example 4 is susceptible to multiple different interpretations. For example, it is possible to interpret Treas. Reg. § 26.2652-1(a)(5) Example 4 in a way that is logically consistent (if still in tension with) the displacement theory. A more detailed discussion of the example can be found *supra* in part VII of this article. Here, it suffices to note that Treas. Reg. § 26.2652-1(a)(5) Example 4, despite being the only authority to address the dueling transferors problem, fails to vindicate either the portion theory or the displacement theory. Advocates of those theories must necessarily find ways to distinguish the regulation. By contrast, the regulation is fully consistent with, and supports the reasoning of, the no effect theory.

C. Gift Tax Case Law Indirectly Supporting the No Effect Theory

It is well-established that an assignment of a beneficial interest of a trust can be subject to gift tax no less than an assignment of any other type of property. As the court put it in *Monroe v. United States*,[148] "there are no statutory exclusions in the Internal Revenue Code which apply" to a gift of an interest in a trust.[149] Treasury regulations even provide a rule for determining the value of such a gift: "If the donor assigns or relinquishes an annuity, life estate, remainder or reversion that the donor holds by virtue of a transfer previously made by . . . another, the value of the gift is the value of the interest transferred."[150] In short, as case law establishes and as Treasury regulations assume, an assignment of a beneficial interest in a trust can be a transfer by gift that is subject to gift tax, just like an assignment of any other type of property.[151]

That said, the rule that gifts of beneficial interests should be subject to gift tax is questionable as a policy matter. By subjecting transfers of beneficial interests to gift tax, the gift and estate taxes end up taxing the

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148 Monroe v. United States, 301 F. Supp. 762 (E.D. Wash. 1969).

149 *Monroe*, 301 F. Supp. at 768.

150 Treas. Reg. § 25.2512-5(d)(2).

151 *See* Hrobon v. Comm'r, 41 T.C. 476, 500 (1964) (holding that the sale of an income interest in exchange for payments equal to 60% of future distributions was a gift equal to 40% of the income interest); s*ee also* Estate of Regester v. Comm'r, 83 T.C. 1, 7 (1984) (indirect relinquishment of the right to income via the exercise of a power of appointment over corpus is a gift equal to the present value of the income interest); *but see* Self v. United States, 142 F. Supp. 939, 942 (Ct. Cl. 1956) (exercise of power of appointment over corpus should not be treated as a gift, even though donee of the power effectively relinquished the right to income from the appointed property).

same property twice. The following example illustrates the harsh consequences of subjecting gifts of beneficial interests to gift tax:

> Example 9: G1 makes a $1 million bequest under G1's will to a trust whose net income is directed to be paid annually in G2a. Upon G2a's death, the remainder is directed to be paid over to G3. Shortly after G1's gift, G2a irrevocably assigns the income interest to G2b for no consideration. The assignment is effective under local law. At the time of G2a's gift, the income interest in the trust is equal to 50% of the value of the trust property, or $500,000.

Here, G2a is subject to gift tax on the $500,000 value of the income interest (ignoring, for simplicity, the gift tax annual exclusion under section 2503 of the Code). Yet the value of the $500,000 income interest was already taxed at G1's death when the $1 million bequeathed to the trust was included in G1's estate. By making a gift of the income interest to another individual, G2a causes the value of the income interest to be taxed a second time. Consequently, although the trust has only $1 million of value, a total of $1.5 million is subject to wealth transfer tax.

The double taxation of the value of the income interest could have easily been avoided. For example, G1 could have simply named G2b as the initial income beneficiary. Alternatively, G1 could have created flexibility to decide who should receive the income from the trust, but without forcing another individual to incur a gift tax. For example, G1 could have given an independent trustee the power to distribute income to either G2a or G2b. In that case, the trustee's decision to distribute income to G2b rather than G2a would not have been subject to gift tax.[152] The trustee would simply be carrying out the disposition of the $1 million without triggering a second tax.

It might be argued that, in the facts of Example 9, G2a's gift of the value of the income interest should be treated the same way as if G1 had given an independent trustee discretion to distribute income to G2b rather than G2a. By providing that the income interest could be assigned, G1 effectively gave G2a the power to decide that the income from the trust should be paid instead to G2b. Just as in the case where G1 gives an independent trustee discretion to choose the recipient of income, G2a's gift of the income interest simply carries out the terms of G1's original disposition. Thus, one might reason, only G1's initial gift to the trust should be subject to gift or estate tax, but not G2a's later gift of the income interest in the trust. Otherwise, the value of the same property is needlessly double taxed.

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152 Treas. Reg. § 25.2511-1(g)(1).

In the end, however, after some initial vacillation,[153] courts rejected the view that a gift of a beneficial interest should not be subject to gift tax.[154] Certainly, by the time the GST tax was enacted, it was clear that a gift of a beneficial interest could be subject to gift tax, even though the value of the interest was already subject to tax. In short, the wealth transfer tax system tolerates double taxation of interests in property held in trust.

Now suppose that a beneficial interest in a trust happens to be transferred down a generation. Example 1 is an illustration:

> Example 1: G1 creates a trust under G1's will whose net income is directed to be paid annually to G2a. Upon G2a's death, the remainder is payable to G2b or G2b's estate. G2b irrevocably assigns G2b's remainder interest to G3 for no consideration. The assignment is effective under local law.

Here, the value of the property that G1 initially transferred to the trust, including both the value of the lead and the remainder interests, is subject to estate tax at G1's death. In addition, the remainder interest in the trust is subject to gift tax upon G2b's assignment of the interest to G3. The value of the remainder interest, therefore, is taxed twice: first, at G1's death, and a second time upon G2b's gift.

As a result of the enactment of the GST tax, the question arises whether the distribution of principal upon G2a's death to G3 should be subject to a *third* tax, namely, a GST tax. Advocates of the displacement theory would argue that the answer should be no; they would point out, correctly, that the value of the remainder interest was already subject to gift tax when G2b assigned the remainder interest to G3. Consequently, according the displacement theory, the principal, when

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153 In *Self v. United States*, 142 F. Supp. 939, 942 (Ct. Cl. 1956), the taxpayer, James Self, was entitled to all of the income of a trust created by his father. The trust instrument gave Self a special power, exercisable during his lifetime, to appoint the corpus of the trust to his descendants. Self exercised the power by directing that a portion of the trust property be paid over to his son and daughter. The Service argued that, by exercising his power of appointment over corpus, Self had effectively transferred to his children the right to the income from the appointed corpus and therefore had made an indirect taxable gift. The court, however, reasoned that Self was merely carrying out the terms of a gift originally made by his father. Consequently, the court held, Self should not be deemed to as having made an additional taxable gift. *Self*'s holding appears limited to situations where an interest is indirectly transferred by the exercise of a special power of appointment. In any event, *Self* appears to be inconsistent with Treas. Reg. § 25.2514-1(b)(2). The Service has also publicly rejected the holding of *Self*, as has the Tax Court. Rev. Rul. 79-327; *Regester*, 83 T.C. at 8. *See also* Walston v. Comm'r, 8 T.C. 72, 80 (1947), *aff'd* 168 F.2d 211 (4th Cir. 1948) (apparent income beneficiary who appointed her interest to another "was executing the decedent's intention as to the disposition of his property, not hers").

154 *Regester*, 83 T.C. at 7.

distributed, should not be subject to an additional GST tax. Instead, G2b should be treated as the transferor of any property paid over to G3 and no GST tax should be imposed.

The displacement theory, in other words, chooses to remedy the perceived potential overtaxation of G2b's gift by interpreting the Code so as to create an exception to the usual rule that a termination of a trust in favor of a skip person is a taxable termination subject to GST tax. As discussed, however, the overtaxation could, in principle, be remedied instead via an exception to the usual gift tax rules. That is, even if the termination of the trust in favor of G3 were subject to GST tax, there would be no overtaxation if G2b's gift were not subject to gift tax. In that case, the remainder interest would be subject to only two levels of wealth transfer tax: first, estate tax at G1's death and, second, GST tax when the trust terminates in favor of G3. An exception to the gift tax rules for gifts of beneficial interests, in other words, would prevent overtaxation just as effectively as the displacement theory's proposed interpretation GST tax rules.

Advocates of the displacement theory do not argue that a gift of a beneficial interest should escape gift tax, for the very good reason that that position is not the law. Yet those same advocates assume that the very same argument against double taxation that has been rejected in the gift tax context should nevertheless prevail in the GST tax context. It is unclear, however, why the GST tax should turn out to be more lenient than the other component taxes in the wealth transfer tax system. On the contrary, if the gift and estate tax system tolerates double taxation of gifts of beneficial interest, then consistency would demand that, once a GST tax is enacted, a gift of a beneficial interest will cause *triple* taxation of the value of such gifts when they are made to skip persons. Fundamental wealth transfer tax principles, in short, are inconsistent with the reasoning underpinning the displacement theory.

D. Estate Tax Case Law Indirectly Supporting the No Effect Theory

As support for the displacement theory, advocates have sometimes cited a line of cases interpreting the meaning of "adequate and full consideration" for purposes of section 2036(a) of the Code. That section appears in the estate tax provisions of the Code and is not a GST tax provision. Nevertheless, as discussed below, the case law interpreting section 2036(a) of the Code has important implications in the GST tax area. As will be seen, however, contrary to advocates of the displacement theory, the cases undermine rather than support the displacement theory.

Section 2036(a)(1) of the Code provides as follows:

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

In general, under this section, if a decedent transferred an interest in property, but retained the right to income from the property for his or her lifetime, the value of the property will be included in his or her gross estate for estate tax purposes. For example, if a decedent made a gift during his or her lifetime of a remainder interest in property, but retained the life estate, the full value of the property would be included in the decedent's gross estate for estate tax purposes.[155] But the parenthetical language in section 2036(a) of the Code contains an exception to this general rule: If the transfer was made in "a bona fide sale for an adequate and full consideration in money or money's worth,"[156] then the property will escape gross estate inclusion.

The meaning of the parenthetical exception, in the case of a sale of a remainder interest in property, has been disputed in a number of cases. In *Wheeler v. United States*,[157] for example, the decedent was the owner of a 376-acre ranch in Texas. In 1984, the decedent sold a remainder interest in the ranch to his adopted sons, in exchange for a note. The government, in a suit by the decedent's estate for refund of estate tax, conceded that the note's value was equal to the actuarial value of the remainder interest at the time of the sale. The decedent's estate argued that, because the decedent sold the remainder interest for its actuarial value, the sale was for "an adequate and full consideration in money or money's worth" within the meaning of parenthetical exception to section 2036(a) of the Code. Consequently, the ranch should not be included in the decedent's gross estate, despite the decedent's retention of a life estate.

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155 Although the heading of section 2036 of the Code refers to "Transfers with Retained Life Estate," the decedent's retained interest need not be in the legal form of a life estate, or even legally enforceable, for section 2036(a)(1) of the Code to apply. *See*, *e.g.*, Estate of Nicol v. Comm'r, 56 T.C. 179, 181-82 (1971); Estate of McNichol v. Comm'r, 265 F.2d 667, 672 (3d Cir. 1959); Skinner's Estate v. United States, 316 F.2d 517, 520 (3d Cir. 1963).

156 I.R.C. § 2036(a).

157 Wheeler v. United States, 116 F. 3d 749 (5th Cir. 1997).

The government, relying the Federal Circuit case of *Gradow v. United States*,[158] disagreed. In the government's view, consideration received by a decedent in exchange for a remainder interest is not "adequate and full" unless the value of the consideration is equal to the *entire* value of the subject property. Otherwise, the government argued, a decedent could artificially deplete his or her gross estate at death by receiving less in value than what would otherwise have been included. As the decedent's sons in *Wheeler* did not pay consideration equal to the full value of the ranch (including both the remainder and the life interest), the sale did not, according to the government, meet the requirements of the parenthetical exception to section 2036(a) of the Code.

The Fifth Circuit in *Wheeler* rejected the government's reasoning. According to the court, a sale of a remainder interest for the actuarial value of the interest (rather than for the value of the entire property) does not achieve a depletion of a decedent's estate. The reason is that "the actuarial value of the remainder interest equals the amount that will grow to a principal sum equal to the property that passes to the remainderman at termination of the retained interest."[159] In other words, if an individual sells a remainder interest in property and retains a life estate, the individual will receive income from the life estate *and* will earn returns on the consideration received in exchange for the remainder interest. Actuarially, the sum of the values of (1) the life interest plus (2) the consideration received the remainder interest is equal to (3) the value of the entire property. Consequently, the court concluded, contrary to the government's position, a sale of a remainder interest for the interest's actuarial value does not, economically speaking, deplete the property that will eventually become subject to estate tax.[160]

The same reasoning that persuaded the Fifth Circuit in *Wheeler* was adopted, in similar cases, by the Third Circuit in *D'Ambrosio v. Commissioner*,[161] and the Ninth Circuit in *Estate of Magnin v. Commissioner*.[162] These cases did not resolve any GST tax issue. Yet their economic analysis of these cases is relevant to the proper resolution of the dueling transferors problem. Example 4 illustrates how the reason-

158 Gradow v. United States., 897 F.2d 415, 519 (Fed. Cir. 1990).

159 *Wheeler*, 116 F. 3d at 755 (citing Martha W. Jordan, Sales of Remainder Interests: Reconciling Gradow v. United States and Section 2702, 14 VA. TAX REV. 671, 673 (1995)).

160 *Id.* at 762.

161 D'Ambrosio v. Comm'r, 101 F.3d 309, 317 (3rd Cir. 1996).

162 *See* Estate of Magnin v. Comm'r, 184 F. 3d 1074 (9th Cir. 1999). By contrast, the Federal Circuit, in *Gradow v. United States*, 897 F.2d 415, 519 (Fed. Cir. 1990), held that a sale of a remainder interest in property in exchange for its actuarial value does not avoid section 2036(a)(1) of the Code.

ing behind the *Wheeler* line of cases applies in the dueling transferors context:

> Example 4: G1 creates a trust under G1's will that permits income or principal to be paid over to G2a during G2a's life in the absolute discretion of the trustee. Upon G2a's death, the remainder is to be paid over to G2b or G2b's estate. G2b makes a gift of the remainder interest to G3. The assignment is effective under local law.

Here, G2b is subject to gift tax on G2b's gift of a remainder interest in the trust created by G1. Under Rev. Rul. 67-370 and other authorities, however, as discussed *supra* in part III of this article, the value of a beneficial interest may be reduced to reflect the possibility that the interest can be curtailed to be defeated by another's discretionary power. In Example 4, the trustee could at any time during G2a's life distribute the entire corpus of the trust to G2a, thereby eliminating the remainder interest. Consequently, it seems that value of G2a's gift would be quite small.

The diminished gift tax value of G2b's gift could significantly underestimate the actual value of the property passing to G3. For example, if the trustee simply fails to make any distributions of income or principal to G2b, all of the trust property, plus all returns on that property during G2a's lifetime, would eventually pass to G3, despite that the value of G2a's gift was reduced by the possibility that distributions could be made to G2a. Yet, according to the displacement theory, G2b should displace G1 as the transferor of any property that passes to G3. In other words, if the displacement theory is correct, despite that G3 is a skip person with respect to the original transferor of the trust, all of the property would pass free of GST tax, at only a minimal gift tax cost to G2b.

In the estate tax context, *Wheeler*, *D'Ambrosio*, and *Magnin* concluded that a sale of a remainder interest for its full actuarial value does not open up opportunities for reducing estate tax, even if the property escapes gross estate inclusion. The reason, in essence, was that the same amount would ultimately be subject to estate tax whether or not there was a sale of a remainder interest for the interest's actuarial value.[163] In Example 4, by contrast, the value of G2a's gift for gift tax purposes may drastically *understate* the value of the property that will ultimately be received by G3. Yet, if the displacement theory is correct, the property passing to G3 would escape GST tax entirely. The amount subject to gift tax, in short, would be far less than the amount ultimately passing to G3.

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163 *But see D'Ambrosio*, 101 F.3d at 319 (Cowen, J. dissenting).

The holdings of *Wheeler*, *D'Ambrosio*, and *Magnin*, therefore, should not give any comfort to the advocates of the displacement theory. Those cases held for the taxpayer on the grounds that the transactions in question would not deplete the amount of property subject to tax. But, as Example 4 illustrates, a gift of a beneficial interest could, if the displacement theory is correct, result in a significant depletion of the amount subject to wealth transfer tax as property passes down generations. If the displacement theory were true, Congress would have left a gaping loophole that would frustrate the purpose for which the GST tax was enacted in the first place, namely, to ensure that property passing multiple generations is taxed at least once a generation. The economic analysis of *Wheeler*, *D'Ambrosio*, and *Magnin*, therefore, cautions against attempting to avoid GST tax through gifts of beneficial interests in trusts.

E. Chapter 14 and the Dueling Transferors Problem

Curiously, despite the implicit condemnation of the displacement theory by *Wheeler*, *D'Ambrosio*, and *Magnin*, advocates of the theory have cited those cases in the theory's favor. It appears that the reason those cases are taken as *support* for the displacement theory is that discussion of the dueling transferors problem to date has focused almost exclusively on gifts of remainder interests in GRATs. In the case of a gift of a remainder interest in a GRAT, there is, arguably, no opportunity for abuse if the displacement theory is correct. Example 2 is an illustration:

> <u>Example 2</u>: G1 funds a GRAT with $1 million and retains the right to receive an annuity for a period of two years. Upon the expiration of the fixed term, any remaining property (after payment of the final annuity amount to G1) is directed to be paid over to G2 (or G2's estate). The present value of the annuity at the time that the GRAT is funded is $999,000, so that G1 makes a taxable gift of $1,000 when the GRAT is created. Shortly after the GRAT is created, G2 irrevocably assigns his remainder interest to G3. The assignment is effective under local law and for gift tax purposes. As a result of returns earned by the GRAT that exceed the section 7520 rate, the remaining property of the GRAT, after the fixed term ends and the final annuity is paid to G1, is $100,000.

Here, the remainder interest in the GRAT is taxed once when the GRAT is created, and a second time when G2 assigns the remainder interest to G3. Thus, advocates of the displacement theory might reason, property passing to G3 is already taxed once a generation, which obviates the policy need to impose a generation-skipping transfer tax.

To be sure, the property transferred to the GRAT might outperform the section 7520 rate, in which case G3 would, as a result, receive significantly more than the initial $1,000 value of the remainder interest. Nevertheless, the GRAT is a statutorily approved device for passing returns in excess of the section 7520 rate free of additional gift or estate tax (if the grantor survives the fixed term). As a policy matter, therefore, it might seem that taxpayers should also be permitted to pass those returns free of GST tax by making gifts of remainder interests.[164]

But the policy argument in favor of the displacement theory, at least in the case of GRATs, ignores the myriad types of beneficial interests, other than remainder interests in GRATs, that can be assigned by gift. For example, as discussed *supra* in part III of this article, beneficial interests that Treasury regulations describe as "restricted" can be assigned as well. Assignments of those types of interests do not enjoy the Congressional blessing that advocates of the displacement theory identify in the context of GRATs. Consequently, the displacement theory does not have policy support as a general matter. On the contrary, as discussed, the theory would undermine the integrity of the GST tax if adopted as the general solution to the dueling transferors problem.

Moreover, if the displacement theory fails as a *general* solution to the dueling transferors problem, it is unclear why it should be nevertheless be accepted as the correct answer in any particular context. Practitioners are accustomed to thinking that, via GRATs, returns in excess of the section 7520 rate can be passed free of tax; hence, they are tempted to believe the displacement theory is correct in the GRAT context. But there are no grounds for thinking that the GST tax consequences of an assignment of a beneficial interest should differ depending on whether the trust in question is a GRAT or some other form of trust. If the displacement theory must be rejected outside of the GRAT context, therefore, it seems that should be rejected within the GRAT context as well.

164 Of course, the inference that taxpayers should be able to avoid GST tax just as easily as gift and estate tax is a *non sequitur*. It is true that, by enacting section 2702 of the Code, Congress authorized taxpayers to create GRATs in order to pass on returns in excess of the section 7520 rate free of gift or estate tax. But it does not follow that Congress also authorized taxpayers to pass on those same returns free of GST tax. On the contrary, as stated in the preamble to proposed regulations under that section, "sections 2701 and 2702 do not apply for purposes of the generation-skipping transfer tax." T.D. 8395, 1992-1 C.B. 316. Further, as discussed in detail *supra* in part IV.D of this article, GRATs are, if anything, one of the most harshly treated forms of trust from a GST tax perspective.

F. Section 2043(a) of the Code and the Dueling Transferors Problem

There is yet another way in which the *D'Ambrosio* trilogy fails to provide support for the displacement theory: namely, that the cases explicitly uphold *over*taxation of partial interests in property. In *Magnin*, for example, the decedent sold a remainder interest in certain closely held stock. The court, like the courts in *Wheeler* and *D'Ambrosio*, held that, if the consideration received by decedent was equal to the value of the remainder interest at the time of the sale, then the stock would not be included in the decedent's gross estate under section 2036(a)(1) of the Code. The Ninth Circuit then remanded to the Tax Court for further proceedings to determine the values, respectively, of the remainder interest and the consideration received.

Before remanding, the court in *Magnin* held that, if it turned out that the value of the consideration was *less* than the value of the remainder interest, then, under section 2043(a) of the Code, the property included in the gross estate under section 2036(a)(1) of the Code should be reduced by the value of the consideration received. In reaching this latter holding, the court recognized that the offset under section 2043(a) of the Code was not fair to the taxpayers. After all, more than thirty-five years had passed between the time that the decedent received consideration for the remainder interest in the stock and the time of the decedent's death. Presumably, in that time, the decedent had earned returns, perhaps very large returns, on the value of the consideration received. Nonetheless, only the value of the consideration received on the transfer, and not any returns on that consideration, were subtracted from the gross estate under section 2043(a) of the Code.

The estate, sensibly, argued that returns on the consideration received by the decedent should be taken into account when computing the gross estate. In the estate's view, the amount of property included in the decedent's gross estate should be reduced not just by the value of the consideration at the time of receipt, but by a percentage of the property included under section 2036(a)(1) of the Code that would be obtained by dividing the value of the consideration by the actual value of the remainder (if greater) at the time of the sale. In this manner, the correct portion of the property, *i.e.*, the portion attributable to the consideration received at the time of the sale, would be subtracted from the gross estate. The *Magnin* court acknowledged that the taxpayer's percentage approach made sense in theory. Nevertheless, the court held that percentage approach was precluded by the statutory language of section 2043(a) of the Code, which only permits a reduction for the value of the consideration received at the time of the sale. In other words, according to *Magnin*, the estate tax provisions had to be interpreted to reach an economically unfair and nonsensical result.[165]

In short, *Magnin* and related cases do not, contrary to the advocates of the displacement theory, forbid overtaxation in cases where there have been assignments of partial interests in property. On the contrary, *Magnin* holds that overtaxation is an acceptable consequence of at least some provisions of the Code. In the case of a gift of a beneficial interest in a trust down to a skip person with respect to the original settlor, we have already seen that triple taxation of the value of the interest is a logical extension of the principle that a gift of a beneficial interest is subject to gift tax. But even if triple taxation were seen as crude and inappropriate, that would not be a decisive consideration in favor of the displacement theory. As *Magnin* shows, the courts are willing to hold for the government, even where doing so results in overtaxation as a policy matter.

G. Conclusion

The no effect theory is not, perhaps, a popular theory. Yet it is the only theory that follows from the general definitions set forth in the Code and Treasury regulations. It is likewise the only theory supported by the only binding authority to address the dueling transferors problem. Finally, the theory is supported by fundamental gift and estate tax principles, as articulated in the case law. In short, the no effect theory, for all its unpopularity, appears to be the correct solution to the dueling transferors' problem.

IX. Sales of Beneficial Interests

This article has focused almost exclusively so far on the GST tax consequences of gratuitous assignments of beneficial interests. But it is also possible for a beneficiary of a trust to assign his or her beneficial interest to another in exchange for consideration. If the consideration received by the assigning beneficiary is equal, in money or money's worth, to the value of the beneficial interest, then the sale is not treated as a gift for gift tax purposes and is not "subject to" gift tax.[166] Thus, a sale for full and adequate consideration does not cause the seller to be treated as the "transferor" of any property for GST tax purposes. Nevertheless, as discussed in this section, the GST tax issues presented by a

[165] *See also D'Ambrosio*, 101 F.3d at 316 (holding that property included in the gross estate under section 2036(a)(1) of the Code, plus the consideration received for the remainder interest, "will be double-taxed, because, all things being equal, the consideration . . . received will also have appreciated and will be subject to tax on its increased value.").

[166] Treas. Reg. §§ 25.2511-1(g)(1), 25.2512-8.

sale of a beneficial interest overlap extensively with those that arise where a beneficial interest is transferred by gift.

A. GST Tax Consequences of Sales of Beneficial Interests: Two Theories

It seems that there are two possible ways of analyzing the GST tax consequences of a sale of a beneficial interest for full and adequate consideration. The two theories are illustrated in the following example:

> Example 10: A trust is created under G1's will for the benefit of G2a and G2b. The trust provides that all income is to be paid to G2a for G2a's life. The trustee also has absolute discretion to pay over principal to G2b. G2a assigns the income interest to G3 in exchange for cash equal to the full actuarial value of the income interest. The assignment is effective under local law.

In this example, G2a sells an income interest to G3 in exchange for a full and adequate consideration in money or money's worth. Consequently, G2a's assignment of the income interest is not subject to gift tax. G2a, therefore, cannot be considered the "transferor" of the income interest, much less of any income that is subsequently distributed to G3.

Nevertheless, it is uncertain, at least at first, whether distributions to G3 should be treated as taxable distributions subject to GST tax. One possible theory, called herein the "no avoidance theory," is that distributions to G3 are taxable distributions subject to GST tax. The no avoidance theory starts with the observation that, after G2a sells the income interest to G3, distributions will be made from the trust to G3, who is a skip person with respect to the transferor of the trust, G1. Those distributions, therefore, according to the no avoidance theory, meet the definition of "taxable distribution," *i.e.*, they are distributions from a trust to a skip person that are not direct skips or taxable terminations.[167] Consequently, even though G3 received the income interest in a sale for a full and adequate consideration, any income distributed to G3 should be subject to GST tax.

The second theory might be called the "avoidance theory." According to the avoidance theory, any income distributions to G3 should be treated, in substance, as if they were received from G2a. That is, the avoidance theory would analyze each distribution from the trust to G3 as consisting of two distinct transfers: first, as a deemed distribution from the trust to G2a, and, second, as a deemed payment by G2a to G3 of the amount distributed from the trust. As G3 would be treated as

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[167] I.R.C. § 2612(b).

receiving distributions from G2a in exchange for an adequate consideration, no GST tax would be imposed. In this manner, the avoidance theory is able to conclude that G3 receives income distributions free of GST tax, despite that G3 is a skip person with respect to the transferor of the trust.

B. The Avoidance Theory and the Displacement Theory

The avoidance theory relies on the same reasoning that was employed in defense of the displacement theory. Indeed, it is perhaps best viewed as a reiteration of the displacement theory, as applied to sales of beneficial interests. Consider, once again, the facts of Example 10:

> <u>Example 10</u>: A trust is created under G1's will for the benefit of G2a and G2b. The trust provides that all income is to be paid to G2a for G2a's life. The trustee also has absolute discretion to pay over principal to G2b. G2a assigns the income interest to G3 in exchange for cash equal to the full actuarial value of the income interest. The assignment is effective under local law.

As discussed, the avoidance theory holds that, following the sale of the income interest to G3, distributions from the trust to G3 should be treated as if they were distributed first to G2a, and then immediately paid over by G2a to G3. Thus, no GST would be due upon the distribution of income to G3, despite that G3 is a skip person with respect to the transferor of the trust.

The arguments in favor of the avoidance theory are as follows:

Substance over form. The first argument in favor of the avoidance theory is that it reflects the substance (albeit not the form) of G2a's sale of the income interest to G3. Formally, G3 receives from G2a a beneficial interest in a trust created by G1. G3 does not, however, receive income from trust corpus directly from G2a. Rather, the income must first be collected by the trustee and then paid over by the trustee to G3.

Nevertheless, according to the avoidance theory, G3 should, in substance, be seen as receiving the income from G2a rather than from the trust. Instead of assigning an income interest to G3, G2a could have retained the income interest but agreed to pay over to G3 the amount of the income as it was distributed from the trust. G3 would, in that case, receive the same amounts as if G2a had, as in Example 10, assigned the income interest to G3. The payments to G3 would be made in discharge of G2b's indebtedness, and, therefore, would not be subject to gift tax[168] and should not have a GST tax consequence.

[168] Comm'r v. Copley's Estate, 194 F.2d 364 (7th Cir. 1952), *acq.* 1965-2 C.B. 4; Rosenthal v. Comm'r, 205 F.2d 505 (2d Cir. 1953).

In Example 10, G2b and G3 choose instead to have G2b assign the income interest in the trust to G3. In substance, any income distributions from the trust to G3 are a series of deferred payments from G2b. As payments from G2b would not have a GST tax consequence if they were made in discharge of a deferred obligation to G3, the avoidance theory reasons, there should likewise not be a GST consequence as distributions are made from the trust directly to G3.[169]

The foregoing substance-over-form reasoning is similar to the substance-over-form reasoning behind the displacement theory. Suppose that, instead of selling the income interest to G3, G2a had chosen to transfer the interest to G3 for no consideration. In that case, G2a's assignment of the income interest would have been subject to gift tax and G2a would have become the "transferor" of the interest for GST tax purposes. In addition, as discussed *supra* in detail in parts V.A-B of this article, the displacement theory would, on substance-over-form grounds, treat any subsequent distributions from the trust to G3 as if they were transferred by G2a to G3 and, therefore, not subject to GST tax. The displacement theory and the avoidance theory, in other words, treat distributions to an assignee beneficiary the same way: the assignee should be treated as receiving distributions not from the trust but from the former, assignor beneficiary.

Prevention of double taxation. Another argument in favor of the avoidance theory is that it prevents double taxation of the value of the income interest. In Example 10, G2a's wealth is not depleted: in exchange for the income interest, G2a receives a consideration that is equal in value to the income interest. The consideration that G2a receives from G3 will ultimately be subject to gift or estate tax once G2a transfers the wealth represented by the consideration, either during lifetime at or death.

Yet if distributions to G3 are taxable distributions, the value of the interest would be taxed twice. That is, the value of the income interest

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[169] An interesting question is whether favorable wealth transfer tax results can, in fact, be achieved through a structured debt instrument whose payment obligations are tied to the amount of distributions from a trust of which the debtor is a beneficiary. Suppose, that is, that G2a in Example 10 does not assign the income interest but accepts a loan from G3, and agrees in exchange to pay over to G3 an amount equal to distributions from the trust. Possibly, neither the debt agreement nor the payments by G2a to G3 would be subject to gift tax. Perhaps, on the other hand, the transaction is vulnerable to attack based on the step transaction doctrine or on other grounds. *Cf*. David A. Handler & Angelo F. Tiesi, *Using Derivatives to "Transfer" Carried Interests in Private Equity, LBO and Venture Capital Funds*, 17 VENTURE CAPITAL REVIEW (Spring 2006) *available at* http://www.kirkland.com/siteFiles/kirkexp/publications/2291/Document1/VCR_Issue17_Kirkland&Ellis.pdf (arguing that section 2701 of the Code can be avoided through a structured debt instrument).

would be taxed, first, as distributions are made from the trust to G3 and subjected to GST tax, and, second, when the consideration received by G2a in exchange for the interest is transferred by lifetime gift or at death. To prevent this result, the avoidance theory reasons, income distributions to G3 should not be considered generation-skipping transfers. Instead, they should be treated as if they were transferred by G2a to G3 in exchange for the consideration.

Once again, the avoidance theory's reasoning is identical to the reasoning underlying the displacement theory. Suppose that, instead of selling the income interest to G3, G2a had chosen to transfer the interest to G3 for no consideration. G2a's assignment of the interest would, in that case, be subject to gift tax. If, in addition, distributions to G3 were taxable distributions subject to GST tax, the value of G2a's gift would in effect be taxed twice: first, upon G2a's gift of the income interest, and a second time when income is distributed to G3 and subjected to GST tax. To prevent this result, as discussed in detail *supra* in part V.A of this article, the displacement theory argues that income distributions to G3 should be treated as if they were transferred by G2a. The displacement theory and the avoidance theory, in other words, both attempt to avoid a perceived overtaxation of wealth where a beneficial interest is assigned down a generation.

C. Technical Flaws of the Avoidance Theory

Given that the avoidance theory relies on the same reasoning as the displacement theory, it is no surprise that the avoidance theory suffers from the same flaws. The errors of the avoidance theory are as follows:

Substance-over-form reasoning not available to taxpayers. As discussed in detail *supra* in part V.B of this article, taxpayers are prohibited under *National Alfalfa* from disavowing the form of their transactions. Rather, having selected a particular course, the taxpayer "must accept the tax consequences of his choice."[170] The rationale for this rule, as discussed *supra* in part VI.D, is especially compelling in the case of assignments of beneficial interests, where the taxpayer can only identify the alleged "substance" of the transaction by assuming that the assignor would be just as willing to pay over future amounts received from the trust to the assignee as to transfer the beneficial interest itself at the time of assignment.

As we have seen, the avoidance theory holds that the purchaser of a beneficial interest should be treated, in substance, as receiving distributions not from the trust but from the seller of the interest. Formally, however, the seller of a beneficial interest does not participate in the

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170 Higgins v. Smith, 308 U.S. 473, 477 (1940).

trustee's distribution decisions. Rather, it is the obligation of the trustee to make distributions directly to the beneficiaries, including to the assignee beneficiary, as required or appropriate under the terms of the trust. Under *National Alfalfa*, the attempt by the avoidance theory to treat the distributions as instead being made by the assignor should fail, just as the identical attempt by the displacement theory should fail.

Wealth transfer tax system tolerates double taxation of beneficial interests. As discussed in detail *supra* in part VIII.C of this article, it is well established that a transfer of a beneficial interest in a trust can cause the value of that interest to be taxed twice. That is, the value of a beneficial interest may be taxed once when a trust is created, and a second time when the beneficial interest is assigned by gift to another. The displacement theory was premised on the assumption that a *third* tax should not be imposed if the beneficial interest is assigned to a lower generation. Yet, as prior case law demonstrates, overtaxation is an acceptable consequence of the wealth transfer tax system. Logically, therefore, contrary to the displacement theory's assumption, the GST tax should, in fact, produce a triple taxation of the value of beneficial interests that are transferred by gift down a generation.

Likewise, as we have seen, the avoidance theory argues that sales of beneficial interests should be treated for GST tax purposes in a manner that will avoid overtaxation of the value of the beneficial interest. Once again, however, prior case law does not require the GST tax provisions to be construed to prevent overtaxation of the value of beneficial interests. The avoidance theory, like the displacement theory from which it derives, is premised on a policy assumption that the courts rejected before the GST tax in its current form was enacted.

Treas. Reg. § 26.2652-1(a)(5) Example 4. As discussed in detail *supra* in part VII.A of this article, Treas. Reg. § 26.2652-1(a)(5) Example 4 is the only binding authority to address the GST tax consequences of an assignment of a beneficial interest. The text of the example is as follows:

> *Effect of transfer of an interest in trust on identity of the transferor*. T transfers $100,000 to a trust providing that all of the net income is to be paid to T's child, C, for C's lifetime. At C's death, the trust property is to be paid to T's grandchild. C transfers the income interest to X, an unrelated party, in a transfer that is a completed transfer for Federal gift tax purposes. Because C's transfer is a transfer of a term interest in the trust that does not affect the rights of other parties with respect to the trust property, T remains the transferor with respect to the trust.

In this example, upon C's gift of the income interest, X becomes the income beneficiary of the trust created by the original transferor, T. The example does not specify X's generation assignment with respect to either T (the transferor of the trust) or C (the transferor of the income interest). Suppose, in any event, that X is a skip person with respect to T. In that case, following C's gift of the income interest, X would be the only individual with an interest in the trust for GST purposes. Thus, it seems that C's gift should trigger a taxable termination subject to GST tax.[171]

As discussed in detail *supra* in part VII.E of this article, however, the displacement theory would disagree. According to the displacement theory, distributions to X should be treated as if they were made first to C, and then immediately paid over from C to X. In other words, the displacement theory would, in effect, treat C, not X, as the owner of the income interest.[172] In this manner, the displacement theory would be able to conclude that, under the facts of Treas. Reg. § 26.2652-1(a)(5) Example 4, no GST tax should be imposed, even if X were a skip person with respect to the original transferor of the trust.

The problem with the displacement theory's analysis (again, as discussed in detail *supra* in part VII.E of this article) is that there is no rule in the Code or Treasury regulations whereby an individual can be *deemed* to have an interest in property held in trust for GST tax purposes. Rather, an individual is only considered to have an interest in property in trust if he or she is actually eligible or entitled to receive income or principal. In the facts of Treas. Reg. § 26.2652-1(a)(5) Example 4, after C makes a gift of the income interest, C is not eligible or entitled to receive income (or principal) of the trust created by T. X, by contrast, becomes entitled to the income of the trust. Thus, following C's gift of the income interest to X, only X, and not C, can be treated as having an interest in the trust for GST tax purposes. If X is a skip person with respect to the transferor of the trust, therefore, a taxable termination should occur upon C's gift.

Unfortunately, Treas. Reg. § 26.2652-1(a)(5) Example 4 is silent on the question of who is considered to have an interest in the trust follow-

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171 An alternative view, which does not affect the analysis of the argument in the text, is that C's gift does not trigger a taxable termination, on the theory that an assignment of an income interest does not constitute a "termination" of the interest within the meaning of section 2612(a) of the Code. In that case, unless the displacement theory is true, subsequent distributions to X, if X is a skip person with respect to T, would be taxable distributions subject to GST tax at the time of transfer.

172 If instead the displacement theory treated X as the owner of the income interest, then advocates of the theory would presumably have to concede that a taxable termination occurs upon C's gift, which is contrary to their view that C's gift should not cause X's interest in the trust to be diminished by GST tax.

ing C's gift. That said, as discussed in detail *supra* in part VII.E of this article, Treasury regulations nowhere provide a rule whereby an individual with no actual interest in a trust can nevertheless be *deemed* to have an interest in trust property for GST purposes. Treas. Reg. § 26.2652-1(a)(5) Example 4's silence, therefore, is best interpreted as indicating that X, not C, has an interest in the trust for GST tax purposes. If that is the case, then, if X is a skip person with respect to T, a taxable termination would occur upon C's gift. C's gift would, in other words, contrary to the displacement theory's proposed treatment, trigger a GST tax on trust property.

As we have seen, the avoidance theory, similar to the displacement theory, holds that an individual who assigns a beneficial interest should continue to be treated as the beneficiary of the trust for GST tax purposes. Suppose, for example, that the facts of Treas. Reg. § 26.2652-1(a)(5) Example 4 were as follows:

> T transfers $100,000 to a trust providing that all of the net income is to be paid to T's child, C, for C's lifetime. At C's death, the trust property is to be paid to T's grandchild. C transfers the income interest to X, an unrelated party, ~~in a transfer that is a completed transfer for Federal gift tax purposes~~ for a full and adequate consideration in money or money's worth.

In these modified facts, C assigns the income interest to C in exchange for a consideration that is equal to the full value of the income interest. Following C's assignment, X becomes the only individual with an interest in the trust for GST tax purposes. Therefore, if X is a skip person with respect to T, it seems that the sale should trigger a taxable termination subject to GST tax.

The avoidance theory, however, holds that X should be treated as receiving any distributions of income not from the trust but from C. Put another way, the avoidance theory would continue to treat C as the income beneficiary of the trust for GST tax purposes. Thus, no taxable termination would occur under the avoidance theory, as there would deemed to be no termination of C's income interest. Yet there is no basis in the Code or Treasury regulations for continuing to treat C as the beneficiary of the trust for GST tax purposes. If the definition of "interest in property held in trust" contemplated that a *former* beneficiary who assigned his or her beneficial interest to another could nevertheless be treated as continuing to have an interest in property held in trust for GST tax purposes, Treas. Reg. § 26.2652-1(a)(5) Example 4 would probably, as discussed in detail *supra* in part VII.E of this article, have said so. That the regulation is silent on whether C can continue to be treated as the beneficiary tends to indicate that, contrary to both the displacement theory and the avoidance theory, the assignor of a beneficial interest cannot be treated as having an interest in property held in trust.

D. Avoidance Theory and Public Policy

A final reason to reject the avoidance theory is that, like the displacement theory, it would undermine the integrity of the GST tax. Consider the following example:

> Example 11: G1 creates a trust under G1's will that permits income or principal to be paid over to G2a during G2a's life in the absolute discretion of the trustee. Upon G2a's death, the remainder is to be paid over to G2b or G2b's estate. G2b sells the remainder interest to G3 in exchange for an amount of cash equal to the interest's full actuarial value.[173] The assignment is effective under local law.

Here, the value of the remainder interest is presumably very small, as it could be defeated at any time if the trustee distributes all of the trust property to G2a. Thus, G3 need only pay a small amount of consideration to G2b in order for the consideration to be full and adequate.

Nevertheless, according to the avoidance theory, the distribution of trust property remaining at G2a's death should be treated for GST tax purposes as if it were distributed first to G2a, and then immediately paid over, free of GST tax, to G3. If that is the correct result, then, to maximize the amount of property that would pass at G2a's death free of GST tax, the trustee could simply fail to make any distributions to G2a during G2a's life, despite that the possibility of such distributions was taken into account when the remainder interest was sold to G3. All of the trust property could then pass to G3 free of GST tax, at minimal cost to G3.

It seems unlikely that, in enacting the GST tax, Congress anticipated that it could be so easily avoided.[174] Fortunately, the avoidance theory, like the displacement theory, appears to suffer from a number of technical flaws. Even if those flaws were not manifest, however, taxpayers should be very cautious before assuming that the avoidance theory correctly analyzes the consequences of a sale of a beneficial interest. The avoidance theory, like the displacement theory, would, if correct, open up significant opportunities for abuse.

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[173] The actuarial value of the remainder interest will be discounted in order to reflect the possibility that the income interest could be curtailed or defeated if the trustee distributes principal to G2b. Rev. Rul. 67-370, 1967-2 C.B. 324 (1967).

[174] *Cf.* United States v. Allen, 293 F.2d 916, 917-18 (10th Cir. 1961) (holding that the decedent's gross estate could not effectively be depleted by a sale of a retained income interest for its actuarial value).

E. The No Avoidance Theory

It might seem that the avoidance theory's rival – called here the "no avoidance theory" – should prevail simply by process of elimination. In any event, the no avoidance theory, like the no effect theory from which it derives, follows in a straightforward interpretation of the general definitions of the Code. Consider, once again, the following example:

> Example 11: G1 creates a trust under G1's will that permits income or principal to be paid over to G2a during G2a's life in the absolute discretion of the trustee. Upon G2a's death, the remainder is to be paid over to G2b or G2b's estate. G2b sells the remainder interest to G3 in exchange for an amount of cash equal to the interest's full actuarial value. The assignment is effective under local law.

Here, G2a's interest in the trust will terminate upon G2a's death. In general, the termination of an interest in trust is a taxable termination subject to GST tax. The exceptions to this general rule are that a termination of an interest in property held in trust is not a taxable termination if (i) a transfer subject to gift or estate tax occurs upon termination, (ii) immediately after the termination, a non-skip person has an interest in the trust property, and (iii) at no time after the termination may distributions be made to skip persons.[175]

None of the exceptions to the definition of taxable termination applies in Example 11. First, the termination of G2a's income interest is not an event subject to gift or estate tax. Second, the only individual with an interest in trust property after the termination of G2a's interest will be G3, who is a skip person with respect to G1. Finally, upon G2a's death, all of the trust property is required to be paid over to G3, who is a skip person with respect to the transferor, G1. Thus, according to the no avoidance theory, the termination of G2a's interest should be a taxable termination subject to GST tax.

Like the no effect theory from which it derives, the no avoidance theory simply calls for the GST tax provisions to be applied in a straightforward fashion, without resort to substance-over-form fictions. As shown above, that approach to interpreting the Code turned out to be sound where beneficial interests are transferred by gift. It is likewise sound where beneficial interests are acquired for full and adequate consideration.

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[175] I.R.C. § 2612(a); Treas. Reg. § 26.2612-1(b).

F. Sales of Beneficial Interest to Other Trusts

The examples so far have considered sales of beneficial interests to individuals. But it is also possible for a beneficiary to sell his or her interest to another trust. The following is an example of a sale of a beneficial interest to a trust rather than to an individual:

> Example 12: A trust ("*Trust 1*") is created under G1's will for the benefit of G2a and G2b. The trust provides that all income is to be paid to G2a for G2a's life. The trustee also has absolute discretion to pay over principal to G2b. G2a creates a separate irrevocable trust ("*Trust 2*") for the benefit of G3. G2a assigns the income interest in Trust 1 to Trust 2 in exchange for cash equal to the full actuarial value of the income interest.[176] The assignment is effective under local law.

Just as if G2a had sold the income interest directly to G3, it seems that there are two possible ways of analyzing the GST tax consequences of any distributions of income from Trust 1 to Trust 2 following Trust 2's purchase of the income interest. The no avoidance theory starts with the premise that G1 is the transferor of Trust 1. The only beneficiary of Trust 2, meanwhile, is G3, who is a skip person individual with respect to G1. Thus, Trust 2 is a skip person trust with respect to G1.[177] In general, a distribution to a skip person is a taxable distribution subject to GST tax.[178] Therefore, according to the no avoidance theory, any distributions from Trust 1 to Trust 2 should be treated as taxable distributions subject to GST tax.

The avoidance theory disagrees. According to the avoidance theory, distributions from Trust 1 to Trust 2 should be treated, in substance, as if they were received by Trust 2 from G2a in exchange for the income interest. Put another way, the avoidance theory would treat distributions from Trust 1 as a return on Trust 2's investment in the Trust 1 income interest. Income distributions, therefore, would not have any GST tax consequences, despite that Trust 2 is a skip person trust with respect to G1.

As we have already seen, the no avoidance theory appears to be the correct theory of the GST tax consequences of a sale of a beneficial interest. Nor does there appear to be a reason to believe that the avoidance theory would be correct in the case of a sale of a beneficial interest to an individual, yet incorrect in the case of a sale of a beneficial interest

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176 The actuarial value of the income interest will be discounted in order to reflect the possibility that the income interest could be curtailed or defeated if the trustee distributes principal to G2b. Rev. Rul. 75-550, 1975-2 C.B. 357 (1975).

177 I.R.C. § 2613(a)(2); Treas. Reg. § 26.2612-1(d)(2).

178 I.R.C. § 2612(b); Treas. Reg. § 26.2612-1(c).

to a trust. Rather, the analysis in both cases should be the same. If the no avoidance theory is correct, therefore, a taxable distribution should occur in Example 12 no less than in Example 10, whose facts are identical but for G2a in Example 10 selling the income interest to an individual rather than to a trust.

G. Sales of Beneficial Interest to Other Trusts: a Dueling Transferors Problem

Sales of beneficial interests to other trusts give rise to one other issue that is not present when a beneficial interest is sold to an individual: namely, whether there is a change of transferors upon a distribution from one trust to another. Consider, once again, the facts of Example 12:

> Example 12: A trust ("*Trust 1*") is created under G1's will for the benefit of G2a and G2b. The trust provides that all income is to be paid to G2a for G2a's life. The trustee also has absolute discretion to pay over principal to G2b. G2a creates a separate irrevocable trust ("*Trust 2*") for the benefit of G3. G2a assigns the income interest in Trust 1 to Trust 2 in exchange for cash equal to the full actuarial value of the income interest. The assignment is effective under local law.

Here, G1 is the transferor for GST tax purposes of Trust 1, while G2a, at least initially, is the transferor of Trust 2. Following the sale of the income interest to Trust 2, income distributions will be made from Trust 1 to Trust 2.

As discussed, the avoidance theory and the no avoidance theory differ as to whether distributions of income, following the sale of the income interest to Trust 2, are taxable distributions subject to GST tax. By the same token, the two theories likewise differ as to the identity of the "transferor" for GST tax purposes of any amounts paid over from Trust 1 to Trust 2. According to the avoidance theory, distributions from Trust 1 to Trust 2 should be treated, in substance, as if Trust 2 received the distributions from G2a in exchange for the income interest. Put another way, the distributions from Trust 1 should be treated as a return on Trust 2's investment in the Trust 1 income interest. As a result, G1 would lose his status as the transferor of any property that is paid over from Trust 1 to Trust 2. G2a would instead displace G1 as the "transferor" and would remain the sole transferor of Trust 2 property.

The no avoidance theory, by contrast, holds that the GST tax treatment of distributions from Trust 1 to Trust 2 should follow form. Thus, any distributions to Trust 2 should be treated as distributions rather than as payments made in exchange for Trust 2's acquisition of the income interest. It seems that, as a general rule, when distributions are made from one trust to another, the identity of the transferor carries over from the first trust to the second, provided that the distributions are not subject to gift or estate tax.[179] In Example 12, distributions of income from Trust 1 to Trust 2 are not subject to gift or estate tax. Thus, according to the no avoidance theory, G1 should continue to be the transferor of any income that is paid over from Trust 1 to Trust 2. Under Treas. Reg. § 26.2654-1(a)(2), if there is more than one transferor with respect to a trust, then the portions attributable to separate taxpayers are treated as separate trusts for GST tax purposes. Thus, Trust 2 would be treated under the no avoidance theory as having two separate trusts for GST tax purposes: one trust, consisting of property derived from G2a's initial gift to the trust, and a second trust, consisting of property derived from distributions from Trust 1.

In any event, the question of whether a trust, such as Trust 2, which has purchased a beneficial interest in another trust, such as Trust 1, acquires a new transferor upon receiving distributions from that other trust comes down to whether the avoidance theory or the no avoidance theory is correct as a general matter. If distributions are treated, in substance, as if they were received in exchange for the consideration paid for the beneficial interest, then G2a will continue to be the sole transferor of all property of Trust 2, even after distributions are made from Trust 1 to Trust 2. If, by contrast, distributions are treated as distributions, then G1's status as the transferor of distributions from Trust 1 will carry over to Trust 2. G1 will then become the transferor of the portion of Trust 2 that is attributable to distributions from Trust 1, while G2a will be the transferor of only the portion of Trust 2 that is attributable to G2a's initial gift to Trust 2. The arguments in favor of each position are the same as those, discussed above, that pertain to whether the distributions are potentially subject to GST tax to begin with.

H. Sales of Beneficial Interests to Trusts Created by the Same Grantor

In some cases, it is possible for one trust to acquire a beneficial interest in a trust created by the same grantor. In that case, there will no question as to the identity of the transferor. Instead, there will be a question as to the correct computation of the applicable fraction of the purchasing trust. The following is an example:

> Example 13: G1 creates an irrevocable long term "dynasty" trust (the "*Dynasty Trust*") for the benefit of all G1's descendants. G1 allocates sufficient GST exemption to give the Dy-

[179] *Cf.* Treas. Reg. § 26.2642-4(a)(2) (providing that a single application fraction must be computed where two trusts created by the same transferor are "consolidated").

> nasty Trust an applicable fraction of 1. G1 also funds a GRAT and retains the right to receive an annuity for a period of years. Upon the expiration of the fixed term, any remaining property (after payment of grantor's right to the final annuity) is directed to be paid over to G2 (or G2's estate). G1 does not allocate GST exemption to the GRAT. Shortly after the GRAT is created, G2 sells the remainder interest in the GRAT to the Dynasty Trust in exchange for remainder interest's then present value.

Here, G1 is the transferor of both the GRAT and the Dynasty Trust. Regardless of whether the avoidance theory or the no avoidance theory is correct, therefore, G1 will be the transferor of any property that, at the end of the fixed term, is paid over from the GRAT to the Dynasty Trust.

Nevertheless, although G1 is the transferor of both trusts, there is still, in a sense, a "dueling" transferors problem presented in Example 13. Treas. Reg. § 26.2642-4(a)(2) provides that, if two trusts created by the same transferor are "consolidated," the applicable fraction of the resulting trust must be recomputed. In Example 13, the GRAT has an applicable fraction of 0, while the Dynasty Trust, at least initially, has an applicable fraction of 1. Upon expiration of the GRAT's fixed term, the remaining property of the GRAT will be paid over to the Dynasty Trust. If the distribution is a consolidation within the meaning of Treas. Reg. § 26.2642-4(a)(2), then the Dynasty Trust's applicable fraction will need to be recomputed. But if the applicable fraction must be recomputed, then, as no GST exemption was allocated to the GRAT, the "nontax portion" added to the Dynasty Trust would be 0, and the Dynasty Trust would lose its applicable fraction of 1.

Once again, the avoidance theory and the no avoidance theory differ as to whether the distribution of the remaining property at termination of the GRAT to the Dynasty Trust is, in fact, a consolidation of two trusts. According the avoidance theory, the distribution from the GRAT to the Dynasty Trust should be treated, in substance, as if the Dynasty Trust received the distribution from G2 in exchange for the remainder interest. In other words, the distribution would be treated as a return on the Dynasty Trust's investment in the GRAT remainder. As a result, despite that, formally, the termination of the GRAT results in a transfer from the GRAT directly to the Dynasty Trust, there would be no consolidation of the two trusts necessitating a recomputation of the applicable fraction. Rather, the Dynasty Trust would retain its application fraction of 1 and its effective exemption from GST tax.

The no avoidance theory, by contrast, holds that the GST tax treatment of distribution from the GRAT to the Dynasty Trust should follow form. That is, the distribution from the GRAT to the Dynasty Trust should, for GST tax purposes, be treated as what it appears to be: namely, a distribution from one trust to another. Thus, according to the no avoidance theory, the GRAT and the Dynasty Trust would be treated as having been consolidated within the meaning of Treas. Reg. § 26.2642-4(a)(2). The Dynasty Trust, in consequence, would lose its applicable fraction of 1.

One again, resolution of the issue – in this case, whether a consolidation of two trusts created by the same transferor occurs where one trust has purchased an interest in the other – comes down to whether the avoidance theory or the no avoidance theory is correct as a general matter. If a distribution from one trust to the other can be treated, in substance, as if it were received in exchange for consideration paid for the beneficial interest, then no recomputation of the applicable fraction would be required. If, by contrast, such a distribution is treated as a distribution from one trust to another, then the applicable fraction will need to be recomputed. The arguments in favor each position are the same as those discussed previously.[180]

I. Conclusion

Sales of beneficial interests present issues similar to those that arise in the context of gifts of beneficial interests.[181] Thus, if one believes that the displacement theory correctly analyzes the GST tax consequences of a gift of a beneficial interest, then one will tend to agree that its sister theory, the avoidance theory, likewise correctly analyzes the GST tax consequences of a sale of a beneficial interest. If instead one believes that the no effect theory is correct, then one will tend to agree that the no avoidance theory correctly analyzes the GST tax consequences of a sale of a beneficial interest. In the end, the displacement theory and the

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180 In a series of PLRs, the Service may have inadvertently accepted the avoidance theory. *See* PLR 200442019 (Apr. 21, 2004); PLR 200442020 (Apr. 21, 2004); PLR 200443023 (Apr. 21, 2004); PLR 201026014 (Feb. 24, 2010); PLR 201026024 (Feb. 24, 2010); PLR 201026025 (Feb. 24, 2010); PLR 201026026 (Feb. 24, 2010); PLR 201026027 (Feb. 24, 2010); PLR 201136011 (June 7, 2011); PLR 201136012 (June 7, 2011); PLR 201136013 (June 7, 2011); PLR 201136014 (June 7, 2011); PLR 201136015 (June 7, 2011).

181 There is one unique situation where it is unclear whether, absent additional regulations, a sale of a beneficial interest succeeds in avoiding GST tax. Suppose that a skip person holds a beneficial interest in a trust, and sells the interest to a non-skip person, such as a charity or the settlor of the trust. The sale itself would not appear at first to be a GST tax event. Yet, if a GST tax is not imposed, the sale would permit the skip person, in effect, to cash out his or her interest free of GST tax. To prevent this result, the Service should issue regulations providing that a skip person who receives consideration in exchange for his or her beneficial interest is treated as receiving a taxable distribution. *Cf.* Rev. Rul. 98-8, 998-1 C.B. 541 (holding that gift or estate tax on qualified terminable interest property cannot be avoided through a purchase of the remainder interest).

avoidance theory ultimately appear to be untenable, while the no effect theory and the no avoidance theory appear to be correct.

X. I.R.S. Authority to Resolve the Dueling Transferors Problem

As argued previously, the no effect theory is the only solution to the dueling transferors problem that appears to be consistent with the Code, Treasury regulations, prior case law in the gift and estate tax area, and public policy as well. Yet the no effect theory is not universally accepted. Indeed, as discussed in further detail below, the Service has not adopted a consistent position on the dueling transferors problem. To eliminate uncertainty and the temptation to take abusive positions, the Service should issue a revenue ruling setting forth the correct analysis of the dueling transferors problem.

A. Reasons for Service Intervention

The Service should intervene to resolve the dueling transferors problem for at least the following four reasons:

Protecting the integrity of the GST Tax. First, the Service should publicly address the dueling transferors problem to protect the integrity of the GST tax. As discussed *supra* in part III and elsewhere in this article, the displacement theory, if sound, would permit taxpayers to escape GST tax at minimal cost. At the same time, the abusive implications of the displacement theory have not deterred the theory's advocates. For example, a recent article[182] has considered the following situation:

> Example 14: G1a creates a trust (the "*Testamentary Trust*") under G1a's will for the benefit of G1b, who is in the same generation as G1a. The Testamentary Trust provides that all income is required to be distributed to G1b. In addition, principal may be paid over to G1b in the absolute discretion of the trustee. G1b assigns the income interest in the Testamentary Trust to a long-term trust for descendants (a "*Dynasty Trust*") for no consideration. The assignment is effective under local law.[183] G1b makes a timely allocation to the Dynasty Trust of an amount of GST exemption equal to the value of G1b's gift.

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[182] Blattmachr et. al., *supra* note 41, at 242 n.63.

[183] One professor has reportedly suggested that, under these circumstances, the Dynasty Trust should be considered "self-settled" and, therefore, potentially subject to the claims of G1b's creditors. *Cf.* N.Y. Est. Powers & Trusts Law § 7-3.1(a) (McKinney 2015). Even if that view is correct, it seems that G1b's gift would still be complete for gift tax purposes, and the Dynasty Trust could still pass free of estate tax at G1b's death, so

The authors of the article correctly observe that, in Example 14, "valuation of the income interest [assigned by G1b] seems to be covered by Rev. Rul. 75-550," which indicates, in the authors' words, that "the value of an income interest is affected by anticipated distributions of corpus."[184] In other words, in virtue of the trustee's retained discretion to distribute principal to the G1b, the value of G1b's gift of the income interest is presumably very small.[185] Likewise, the GST exemption that G1b attempts to allocate to the Dynasty Trust is likewise presumably small.

Despite the reduced value of the G1b's gift, the authors conclude that G1b would "probably" become the transferor of any income paid over from the Testamentary Trust to the Dynasty Trust.[186] In other words, the authors advocate the displacement theory: Although the value of G1b's gift may understate the amount of income that will actually be paid over to the Dynasty Trust, the authors nonetheless contend that G1b will displace G1a as the transferor of any such income. As a result, in the authors' view, the minimal GST exemption allocated to the Dynasty Trust by G1b should be sufficient to cause the Dynasty Trust to be effectively exempt from GST tax.[187] Thereafter, by simply refraining

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long as the Dynasty Trust is created in a "domestic asset protection" jurisdiction that generally permits self-settled trusts to be protected against claims of creditors. *See* PLR 200944002 (July 15, 2009); Rev. Rul. 2004-64, 2004-2 C.B. 7, 2004.

184 Blattmachr et al., *supra* note 41, at 244 n.63.

185 For technical reasons outside the scope of this article, the special valuation rule of section 2702 of the Code did not apply in the hypothetical considered by Jonathan G. Blattmachr et. al., authors of *Portability or No: The Death of the Credit Shelter Trust?*, discussed *supra* note 41 and accompanying text. The reason is that G1b was G1a's surviving spouse and G1a's executors made an election under section 2056(b)(7) of the Code to treat the trust as "qualified terminable interest property." Thus, upon transferring the income interest, G1b was treated, under section 2519 of the Code, as having made a gift not only of the income interest but also of the principal of the trust. As a result, G1b was deemed for gift tax purposes to have transferred all of the interests in the trust, and did not "retain" any interest, as required for section 2702 of the Code to apply.

186 For a more skeptical view, *see* Harrington et al., *supra* note 1, ¶ 9.12(5).

187 In the situation considered by the authors, G1a's executors happened to have allocated sufficient GST exemption to the Testamentary Trust to make it effectively exempt from GST tax. The displacement theory, in that case, actually results in a modestly adverse GST tax consequence: if the displacement theory is correct, then any GST exemption allocated by G1a will effectively be lost as income is paid over to the Dynasty Trust, as G1b would displace G1a as the transferor of income at the moment of distribution. Conversely, the no effect theory actually has a modestly favorable GST tax consequence: under the no effect theory, the effective exemption against GST exemption that the Testamentary Trust enjoys, including with respect to income paid over to the income beneficiary, would not be lost just because G1b makes a gift of her income interest to the Dynasty Trust. The modestly favorable consequences under the no effect theory do not raise policy concerns. If a "leaky" zero inclusion ratio trust is later converted into a trust that does not force distributions to non-skip beneficiaries, the result is the same as if the

to make principal distributions to G1b, the trustee can maximize the income passing free of GST tax to the Dynasty Trust. In short, the authors of the article imply, G1b can cause property to pass free of GST tax at an artificially reduced gift tax cost.

The Service need not respond publicly, of course, to every tax avoidance scheme dreamt up by taxpayers and their advisors. Unfortunately, as discussed below, the Service itself has not given clear guidance on the solution to the dueling transferors problem. As a result, the Service has allowed a situation to develop where many taxpayers may be led to believe that a gift of a beneficial interest can cause a change of transferors of underlying trust property. The displacement theory should be strangled in its cradle before it does any further damage to the integrity of the wealth transfer tax system.

Clarifying inconsistent and unpersuasive informal guidance. A second reason for the Service to intervene in the dueling transferors problem is that the Service's informal guidance to date has created undue uncertainty. For example, while the Service in PLR 200107015 rejected the displacement theory in the case of a gift of a remainder interest in a CLAT, that ruling, as discussed *supra* in parts IV and VI of this article, is flawed in a number of important respects. Ironically, the very weaknesses of the ruling may even be giving comfort to advocates of the displacement theory.

In the first place, the Service based its rejection of the displacement theory on narrow policy grounds. Specifically, the Service argued that a gift of a remainder interest in a CLAT is an attempt to circumvent the rule of section 2642(e) of the Code. But that rule has no application outside of the CLAT context. (To be sure, as argued *supra* in part IV.E of this article, the policy objections expressed in PLR 200107015[188] should be understood to apply much more broadly than the CLAT context.) Some may view the ruling, therefore, as implicit support for the view that the displacement theory should be correct wherever section 2642(e) of the Code is not implicated.

Second, in PLR 200107015, the Service failed to cite any technical reasons to reject the displacement theory. In particular, the ruling does not analyze the definition of "transferor" or apply it to the case of a gift

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original settlor had initially created an accumulation trust with a zero inclusion ratio, as clearly permitted by the Code. In any event, the Code does not have one definition of "transferor" for trusts to which GST exemption has been allocated, and another definition for trusts to which no GST exemption has been allocated. Thus, whatever the correct resolution of the dueling transferors problem, the same solution should apply both to trusts to which GST exemption has been allocated and to trusts to which no GST exemption has been allocated.

[188] PLR 200107015 (Nov. 14, 2000).

of a beneficial interest. Nor does the ruling cite or distinguish the one binding authority to address the dueling transferors problem, namely, Treas. Reg. § 26.2652-1(a)(5) Example 4. Thus, casual readers of the ruling might be tempted to conclude that there are no good reasons, based on the language of the Code and Treasury regulations, to reject the displacement theory.

As discussed *supra* in part V.C of this article, nothing could be further from the truth. The displacement theory appears to rest, in the final analysis, on the almost superstitious assumption that an individual can be treated as the "transferor" of property other than that which he or she has actually transferred for gift or estate tax purposes. Still, PLR 200107015 fails to expose the weaknesses of the displacement theory. Thus, the ruling has the practical effect of misleading taxpayers and their advisors into thinking that there is merit to the displacement theory after all.

Third, PLR 200107015 embraces an alternative theory, the portion theory, that itself suffers from serious flaws. To be sure, the portion theory does not open up the opportunities for abuse that would be available under the displacement theory. But, as discussed *supra* in part VI.C of this article, the portion theory leads to inappropriate results and rests, just like the displacement theory, on a misunderstanding of the definition of "transferor." The weaknesses and illogicality of the portion theory, once again, may lead taxpayers to believe that its rival, the displacement theory, is the stronger theory.

Finally, PLR 200107015 is not the only time that the Service has mishandled the dueling transferors problem. In a series of private rulings involving sales of remainder interests, the Service actually appears to have taken a position in favor of displacement theory.[189] In those rulings, the remaindermen of a testamentary trust sold their beneficial interests for full and adequate consideration to separate trusts created by the remaindermen. The Service stated, "We note that, under § 2652(a)(1), Grandchild 1 [*i.e.*, the seller of the remainder interest] is the transferor of Trust 1, Trust 2, Trust 3, Trust 4, and Trust 5 [*i.e.*, the separate trusts created by the seller] for GST tax purposes." Although the meaning of the comment is unclear, it suggests that the remaindermen of the testamentary trust, who sold their remainder interests to separate trusts that they created, are the transferors of any property paid over from the testamentary trust. As discussed *supra* in part IX.F of this

[189] *See* PLR 200442019 (Apr. 21, 2004); *see also* PLR 200442020 (Apr. 21, 2004); PLR 200443023 (Apr. 21, 2004); PLR 201026014 (Feb. 24, 2010); PLR 201026024 (Feb. 24, 2010); PLR 201026025 (Feb. 24, 2010); PLR 201026026 (Feb. 24, 2010); PLR 201026027 (Feb. 24, 2010); PLR 201136011 (June 7, 2011); PLR 201136012 (June 7, 2011); PLR 201136013 (June 7, 2011); PLR 201136014 (June 7, 2011); PLR 201136015 (June 7, 2011).

article, that conclusion is probably incorrect: the settlor of the testamentary trust, as the transferor of that trust, should continue to be treated as the transferor of any property paid over to the separate trusts created by the remaindermen. Furthermore, the comment appears to be inconsistent with the position the Service took in PLR 200107015 and allows a GST tax planning opportunity that Congress may not have intended.[190] The rulings, in short, have contributed to the uncertainty to an already difficult area.

Insufficient regulatory guidance. Treas. Reg. § 26.2652-1(a)(5) Example 4 is the only binding authority that directly addresses the GST tax consequences of an assignment of a beneficial interest in a trust. The example concludes that, following the assignment by the income beneficiary of the income interest, the original settlor of the trust "remains the transferor with respect to the trust."[191] The conclusion, as discussed in detail *supra* in part VII.A of this article, is difficult to reconcile with either the portion theory or the displacement theory. Meanwhile, the example provides direct support for the no effect theory, which, just like the example, holds that a gift of a beneficial interest does not cause a change of transferors of underlying trust property.

Nevertheless, as discussed in detail *supra* in part VII.B of this article, the example leaves open a number of unaddressed questions. Not surprisingly, therefore, advocates of the displacement theory have found ways to distinguish it.[192] The ambiguities of the example may also explain why the Service has itself failed to discuss or even cite the example

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190 The testamentary trust in the rulings was "grandfathered" against GST tax, while the purchasing trusts created by the remaindermen were not. Thus, if the no effect theory is true, the settlor of the testamentary trust, who occupied a generation several degrees higher than that of the beneficiaries of the purchasing trusts, would be considered the "transferor" of property held by the purchasing trusts and a GST tax would be imposed upon a taxable distribution or taxable termination. By contrast, if the displacement theory is correct, the settlors of the purchasing trusts, who occupied a lower generation than the settlor of the testamentary trust, would displace the settlor of the testamentary trust as the "transferors" of property paid over from the testamentary trust. Thus, in effect, the taxpayers in the rulings would be allowed, under the displacement theory, to artificially extend the period when "grandfathered" trust property may pass free of GST tax.

191 Treas. Reg. § 26.2652-1(a)(5) (ex. 4).

192 Jonathan G. Blattmachr et al., the authors of *Portability or No: The Death of the Credit Shelter Trust?*, discussed *supra* note 41 and accompanying text, for example, read Treas. Reg. § 26.2652-1(a)(5) Example 4 as merely confirming that the original settlor remains the transferor of the principal passing to the remainder beneficiary, regardless of the length of the measuring life. The authors implicitly deny that example can also be read as holding that the original settlor remains the transferor of any income paid over to the donee income beneficiary. The actual language of the example's conclusion – that the original settlor remains the transferor "with respect to the trust" – does not distinguish between principal and income and, therefore, suggests that the original settlor re-

in the Service's various rulings to address the dueling transferors problem. Unfortunately, therefore, Treas. Reg. § 26.2652-1(a)(5) Example 4 is not itself sufficient to discourage taxpayers and their advisors from relying on the displacement theory.

B. Intervention via Revenue Ruling

The Treasury Department, in addition to its general rule-making authority,[193] has broad authority under section 2663 of the Code to issue regulations to carry out the purposes of the GST tax. It seems, therefore, that the Treasury could promulgate additional regulations that address the GST tax consequences of assignments of beneficial interests. Yet it is not necessary or even desirable for the Service to do so. Instead, as discussed below, the Service should address the dueling transferors problem by issuing a revenue ruling.[194]

The advantages of a revenue ruling are as follows:

Efficiency of revenue ruling publication process. Publication of new Treasury regulations must generally comply with the procedures of the Administrative Procedure Act.[195] Those procedures do not apply to the Service's issuance of revenue rulings.[196] At the same time, taxpayers may rely on revenue rulings as the Service's official interpretation of the

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mains the transferor of all trust property, including both the principal passing to the remainderman and the income paid over to the donee of the income interest.

[193] I.R.C. § 7805(a) ("[T]he Secretary shall prescribe all needful rules and regulations for the enforcement of this title, including all rules and regulations as may be necessary by reason of any alteration of law in relation to internal revenue."). Historically, courts applied different standards of deference to Treasury regulations depending on whether they were authorized by a specific Code section or under the general rule-making authority in section 7805(a) of the Code. However, in a recent decision, the Supreme Court appears to have eliminated this distinction, ruling instead that the same standard of deference is applicable irrespective of the Service's authority to issue the regulations. Mayo Found. for Educ. Research v. United States, 562 U.S. 44, 55-57 (2011) ("Chevron deference is appropriate when it appears that Congress delegated authority to the agency generally to make rules carrying the force of law, and that the agency interpretation claiming deference was promulgated in the exercise of that authority. Our inquiry in that regard does not turn on *whether Congress's delegation of authority was general or specific*." (emphasis added) (internal citations omitted)); *but see* Andrew Pruitt, *Judicial Deference to Retroactive Interpretative Treasury Regulations*, 79 GEO. WASH. L. REV. 1558, 1570-71 (2011) (arguing that *Chevron* deference may not apply to Treasury regulations issued pursuant to section 7805(b) of the Code, despite the Supreme Court ruling in *Mayo Foundation*).

[194] Treas. Reg. § 601.201(a)(1), (6) (addressing the Service's function in issuing Revenue Rulings).

[195] 5 U.S.C § 553(b), (c). The Service has codified its procedures for the implementation of these rules in the Treasury regulations. *See* Treas. Reg. § 601.601.

[196] 5 U.S.C 553(b)(3)(A) ("[T]his subsection does not apply— to interpretative rules, general statements of policy, or rules of agency organization, procedure, or practice.").

Code and Treasury regulations[197] and the Service generally may not disavow them.[198] Thus, at a minimum, a revenue ruling addressing the dueling transferors problem could provide more immediate guidance than additional Treasury regulations.

No implication of change in law. The exercise of the Service's "legislative" authority to make new rules would not be appropriate to resolve the dueling transferors problem. As argued in this article, the correct solution to the dueling transferors problem already follows from the Code's definition of "transferor." Thus, new rules are not required to establish that a gift of a beneficial interest does not cause a change in the identity of the transferor of underlying trust property. Moreover, the Service may not generally issue new rules that have retroactive effect,[199] whereas a resolution of the dueling transferors problem should be based on an interpretation of existing rules and, therefore, should apply retrospectively.

Possible Auer/Seminole Rock *deference*. The deference due to revenue rulings remains an evolving area. At a minimum, it seems that revenue rulings are entitled to so-called *Skidmore* deference,[200] according to which agency pronouncements are entitled to deference to the extent of their "power to persuade."[201] It is possible, however, that a revenue ruling interpreting the Service's own regulations would be entitled to the higher level of deference articulated in *Bowles v. Seminole Rock & Sand Co.*,[202] and *Auer v. Robbins*.[203] In *Auer*, the Supreme Court held that an agency's interpretation of its own regulation controls, provided that is not plainly inconsistent with the regulation or errone-

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197 Rev. Proc. 89-14, 1989-14 C.B. 814 at 7.01(4). ("Revenue Rulings published in the Bulletin do not have the force and effect of Treasury Department regulations (including Treasury Decisions), but are published to provide precedents to be used in the disposition of other cases, and may be cited and *relied upon* for that purpose.") (emphasis added).

198 *See* Rauenhorst v. Comm'r, 119 T.C. 157, 171 (2002). There may be an exception for revenue rulings that are contrary to statute. Schleier v. Comm'r, 515 U.S. 323, n.8 (1995).

199 *See* Bowen v. Georgetown Univ. Hosp., 488 U.S. 204, 215 (1988).

200 *See* Kornman & Assoc. v. United States, 527 F.3d 443, 455 (5th Cir. 2008) ("[T]he various circuit courts addressing this issue have held that revenue rulings are entitled to *Skidmore* deference. . . . and we apply that standard today."); *See* Taproot Admin. Serv., Inc. v. Comm'r, 679 F.3d 1109, 1115 (9th Cir. 2012) ("As both parties concede, I.R.S. revenue rulings are entitled to the degree of deference articulated by the Supreme Court in *Skidmore* . . . .").

201 United States v. Mead Corp., 533 U.S. 218, 228 (2001). *Skidmore* deference may not amount to much in practice. *Mead,* 533 U.S. at 250. ("[T]he rule of *Skidmore* deference is an empty truism and a trifling statement of the obvious: A judge should take into account the well-considered views of expert observers.") (Scalia, J. dissenting).

202 Bowles v. Seminole Rock & Sand Co., 325 U.S. 410, 414 (1945).

203 Auer v. Robbins, 519 U.S. 452 (1997).

ous.[204] Some have suggested that *Auer* deference should apply to revenue rulings interpreting Treasury regulations.[205] If *Auer* deference did apply to a revenue ruling embracing the no effect theory, then even a court that disagreed with the ruling's conclusion would be required to uphold the Service's position, provided that the position is not plainly inconsistent with Treasury regulations or erroneous. As the no effect theory is not plainly inconsistent with Treasury regulations or erroneous, *Auer* deference, if it applied, would, it seems, compel courts to uphold a revenue ruling embracing the no effect theory.

Taxpayer risk in taking positions contrary to revenue rulings. A final reason for the Service to publish a revenue ruling is that taxpayer penalty provisions would give such a ruling sufficient teeth. In general, under section 6662(b)(1) of the Code, taxpayers are subject to penalties for the portion of any underpayment that is attributable to negligence or disregard of rules and regulations.[206] For this purpose, "rules and regulations" include revenue rulings.[207] Taxpayers who take a position contrary to a revenue ruling (other than with respect to a reportable transaction) are not considered to have disregarded the ruling if the "contrary position has a realistic possibility of being sustained on its merits."[208] Such a "realistic possibility" apparently exists where a reasonable and well-informed analysis by a person knowledgeable in the tax law would lead such a person to conclude that the position has approximately a one in three, or greater, likelihood of being sustained on its merits.[209] The displacement theory, perhaps, is so contrary to the Code's definition of "transferor," not to mention public policy, as to fail this "realistic possibility" standard. Thus, any taxpayer who defied the Service's position in a revenue ruling embracing the no effect theory would be at risk of incurring an accuracy-related penalty.[210]

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204 *See Auer*, 519 U.S. at 461. Although some justices have expressed willingness to reexamine *Auer*, it remains good law. Decker v. Nw. Envtl. Def. Ctr., 133 S. Ct. 1326, 1338 (2013) (Roberts, C.J., concurring).

205 *See* Steve R. Johnson, Auer/Seminole *Rock Deference in the Tax Court*, 11 PITT. TAX. REV. 1, 34 (2013); Ellen P. Aprill, *A Case Study of Legislation vs. Regulation: Defining Political Campaign Intervention Under Federal Tax Law*, 63 DUKE L.J. 1635, 1642 (2014).

206 Taxpayers may generally avoid the penalty if there was reasonable cause for the underpayment and the taxpayer acted in good faith. I.R.C. § 6664(c).

207 Treas. Reg. § 1.6662-3(b)(2).

208 *Id.*

209 Former Treas. Reg. § 1.6694-2(b) (prior to amendment by T.D. 9436, 2009-3 I.R.B. 268 (Dec. 22, 2008)).

210 Moreover, any tax advisor would presumably have to take the ruling into account in rendering an opinion on the transaction.

C. Scope of Revenue Ruling on the Dueling Transferors Problem

Should the Service choose to issue a revenue ruling on the dueling transferors problem, the ruling should state clearly that the no effect theory correctly applies the Code's definition of "transferor" to assignments of beneficial interests, as well as distributions to assignee beneficiaries. The ruling should also address gifts of both lead and remainder interests. Finally, the revenue ruling should address the GST tax consequences of sales of beneficial interests for full and adequate consideration.

XI. Conclusion

Whether GST tax can be avoided through assignments of beneficial interests is one of the most difficult questions in the GST tax arena. The very difficulty of the problem likely explains why it has seldom been analyzed in depth. After thinking the problem all the way through, however, it seems that the answer is simple: the assignment of a beneficial interest in a trust, whether by gift or in a sale for full and adequate consideration, does not permit property to pass down generations free of GST tax. The Service can and should publicly adopt that conclusion. Even if the Service fails to act, taxpayers and their advisors should not assume that a change of transferor can occur, and GST tax savings can be achieved, by an assignment of a beneficial interest in a trust.