Loyola of Los Angeles Law Review

Volume 55 | Number 2 Article 6

Spring 5-11-2022

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SUBSTANCE OVER FORM IN TRANSFER TAX ADJUDICATION

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The elevated exemption level under the federal transfer tax system (now in excess of $24 million for a married couple) has opened up new and abusive tax-avoidance opportunities. In many areas of the tax law, the substance over form doctrine historically has been effective in controlling such abuses; however, for a myriad of reasons, transfer tax jurisprudence has been marred by the reluctance of courts to embrace this doctrine. In this analysis, we urge reconsideration of that posture.

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I. INTRODUCTION

A well-accepted principle of tax law interpretation is that the substance, not the form, of a transaction should dictate its consequences.[1] Conceived in the early years of tax jurisprudence by the U.S. Supreme Court,[2] this principle has developed into a doctrine that has a rich and detailed heritage.[3] Commonly invoked by the Internal Revenue Service (IRS),[4] it is an effective tool in controlling taxpayers' efforts to

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1. The United States Supreme Court stated as follows:

> [T]he Government may not be required to acquiesce in the taxpayer's election of that form for doing business which is most advantageous to him. The Government may look at actualities and upon determination that the form employed for doing business or carrying out the challenged tax event is unreal or a sham may sustain or disregard the effect of the fiction as best serves the purposes of the tax statute. To hold otherwise would permit the schemes of taxpayers to supersede legislation in the determination of the time and manner of taxation.

Higgins v. Smith, 308 U.S. 473, 477–78 (1940).

2. As early as 1921, in the U.S. Supreme Court's analyses of the then recently introduced modern income tax, the Court shied away from pure textualism. *See* United States v. Phellis, 257 U.S. 156, 168 (1921) ("We recognize the importance of regarding matters of substance and disregarding forms in applying the provisions of the Sixteenth Amendment and income tax laws enacted thereunder."); *see also* Weiss v. Stearn, 265 U.S. 242, 254 (1924) ("Questions of taxation must be determined by viewing what was actually done, rather than the declared purpose of the participants, and when applying the provisions of the Sixteenth Amendment and income laws enacted thereunder we must regard matters of substance and not mere form.").

3. In her article, Linda D. Jellum noted:

> Using nontextualist approaches, the Court long ago crafted common law rules of interpretation, or doctrines, which require a transaction to satisfy *both* the statute's language and its underlying purpose; satisfying the literal words of the statute is not sufficient. These anti-abuse doctrines collectively permit the Service to reject a taxpayer's characterization of a business transaction arguably meeting the precise terms of a tax statute, but simultaneously seeking tax benefits Congress did not intend.

Linda D. Jellum, *Codifying and "Miscodifying" Judicial Anti-Abuse Tax Doctrines*, 33 VA. TAX REV. 579, 590 (2014) (footnote omitted); *see also* Philip Sancilio, Note, *Clarifying (or Is It Codifying?) the "Notably Abstruse": Step Transactions, Economic Substance, and the Tax Code*, 113 COLUM. L. REV. 138, 141 (2013) ("The general principle that taxation should give effect to transactions' substance, rather than their form, underlies much of tax law and impels many more specialized doctrines, including the economic substance and step transaction doctrines." (footnote omitted)); Alan Gunn, *The Use and Misuse of Antiabuse Rules: Lessons from the Partnership Antiabuse Regulations*, 54 SMU L. REV. 159, 160 (2001) ("For most of our tax history, attempts by taxpayers to exploit the wording of particular Code provisions have been struck down on various grounds: substance over form, lack of business purpose, lack of non-tax substance, and the ubiquitous if obscure 'step-transaction doctrine.'").

4. Insofar as the substance over form doctrine is concerned, the general consensus is that the Commissioner has the upper hand in invocation. This sentiment was expressed by Judge Seitz in *Commissioner v. Danielson*, 378 F.2d 771 (3d Cir. 1967), when he declared:

> Where the Commissioner attacks the formal agreement the Court involved is required to examine the 'substance' and not merely the 'form' of the transaction. This is so for the very good reason that the legitimate operation of the tax laws is not to be frustrated by forced adherence to the mere form in which the parties may choose to reflect their transaction. . . . In contrast, the Commissioner here is attempting to hold a party to his

skirt their income tax obligations.[5] The familiar fact pattern that often unfolds is as follows: taxpayers engage in a transaction designed to reduce their tax obligations that is in compliance with the literal dictates of the Internal Revenue Code ("Code") yet is wholly devoid of economic substance; the IRS audits the taxpayers' tax returns and proposes an assessment; the matter is adjudicated in court; and the judiciary unapologetically employs the substance over form doctrine to characterize more accurately the putative transaction, according the recharacterized transaction the less attractive tax consequences that it deserves.[6]

But when it comes to adjudications involving the transfer tax regime—estate, gift, and generation-skipping transfer taxes, which have played an important role in shaping the nation's tax landscape—the emphasis that the judiciary places on the substance of a transaction, rather than its form, is curiously anemic.[7] That absence has emboldened taxpayers to use the Code's literal language in ways that they

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> agreement unless that party can show in effect that it is not truly the agreement of the parties. And to allow the Commissioner alone to pierce formal arrangements does not involve any disparity of treatment because taxpayers have it within their own control to choose in the first place whatever arrangements they care to make.

Id. at 774–75 (internal citations omitted).

However, courts have occassionally granted liberty to taxpayers to invoke the substance over form doctrine as well. *See* Robert Thornton Smith, *Substance and Form: A Taxpayer's Right to Assert the Priority of Substance*, 44 TAX LAW. 137 *passim* (1990) (emphasizing the fact that taxpayers, too, can invoke the use of this doctrine); Ciaio v. Comm'r, 47 T.C. 447, 457 (1967) ("The taxpayer as well as the Government is entitled to the benefit of the rule that the substance rather than the form of a transaction controls." (citing Landa v. Comm'r, 206 F.2d 431, 432 (D.C. Cir. 1953))).

5. *See, e.g.*, Est. of Weinert v. Comm'r, 294 F.2d 750, 755 (5th Cir. 1961) (noting that "[t]he principle of looking through form to substance . . . is the cornerstone of sound taxation").

6. In his article, Peter C. Canellos noted:

> Once a judge sees the transaction as a shelter, a function of inferences that experienced judges are capable of making based on all the facts, the result is predictable—taxpayer loses. The Tax Court, in particular, seems to have accepted the view that the strain on the tax system would be unbearable if tax-motivated transactions had to be sustained merely because they manage to encapsulate an uneconomic tax rule, however clear by its terms. This result-oriented outlook resembles the approach of appellate courts, which often strive mightily not to reverse a criminal conviction on procedural grounds where guilt is clear. The shelter promoter who loses on a claim for unreasonable tax benefits despite good technical arguments based on arcane provisions and choreographed scenarios does not deserve or receive much sympathy.

Peter C. Canellos, *A Tax Practitioner's Perspective on Substance, Form and Business Purpose in Structuring Business Transactions and in Tax Shelters*, 54 SMU L. REV. 47, 65 (2001).

7. Jay A. Soled, *Use of Judicial Doctrines in Resolving Transfer Tax Controversies*, 42 B.C. L. REV. 587, 599–604 (2001).

claim support their transfer tax machinations even when the essence of what they are doing is entirely artificial.[8]

This analysis offers possible explanations for the fact that the substance over form doctrine is vibrant in one context yet largely dormant in the other. First, it explores the origin of the substance over form doctrine and discusses its role in resolving income tax disputes. Next, utilizing three representative case studies, this analysis examines several transfer tax–minimization techniques in which taxpayers elevate form over substance but that the courts nevertheless approve. Third, the analysis offers several explanations regarding the judiciary's position and then discusses its consequences. Fourth, the analysis argues that the sanctity of the transfer tax system requires not only that Congress consider taking ameliorative reform measures to address circumventions of the transfer tax rules but also that the judiciary be more receptive to use of the substance over form doctrine in handling transfer tax adjudications. A brief concluding section follows.

II. BACKGROUND: THE SUBSTANCE OVER FORM DOCTRINE

Tax professionals generally understand that the tax treatment of a transaction is to be determined by the *substance* of the transaction rather than by its *form.*[9] That, at least, is the ideal—though it is not always achieved.

In the famous case of *Helvering v. Gregory*,[10] Judge Learned Hand articulated an elegant explanation of the ideal. In that case, Mrs. Gregory owned all of the shares of a parent corporation, which in turn owned appreciated shares of a wholly owned subsidiary corporation.[11] Mrs. Gregory wanted to sell the subsidiary's shares but knew that if the parent corporation distributed these shares directly to her, this

8. For examples of this phenomenon, see *infra* Part III.

9. Joseph Isenbergh, *Musings on Form and Substance in Taxation*, 49 U. CHI. L. REV. 859, 863 (1982) (reviewing BORIS I. BITTKER, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS (1981)) ("[T]here is almost universal assent among tax lawyers and theorists that the revenues should not be defeated by certain entirely artificial maneuvers. We are assured—and it would be hard to demur—that the 'substance' of events should determine their tax consequences . . . ."); *see, e.g.*, Craig W. Friedrich, *Purchase of Stock of Corporation After Corporation Purchases Debt of Purchaser of Stock Does Not Avoid Cancellation of Indebtedness Income*, 19 J. REAL EST. TAX'N 162, 162 (1992) ("The hardest class of judgment any tax professional makes . . . is deciding when the form of a transaction will govern for tax purposes and when some 'substance' discerned through the form will control instead. Good tax professionals, having had broad experience with form and substance issues, develop a reliable gut instinct that detailed research can focus but never really substitute for making the final leap to judgment.").

10. 69 F.2d 809 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935).

11. *Id.* at 810.

would constitute a taxable dividend of the full fair market value of such shares, taxable at ordinary income rates.[12]

To avoid this unattractive financial outcome, Mrs. Gregory engaged in what she claimed was a tax-free reorganization.[13] As part of the putative tax-free reorganization, Mrs. Gregory employed the following four-step process:

(1) She established a new corporation in which she was the sole shareholder.
(2) She then had the original parent corporation transfer its subsidiary shares to the newly formed corporation established pursuant to a reorganization.
(3) A few days later, Mrs. Gregory liquidated the new corporation and had it transfer its subsidiary shares to her (these were the same shares that the newly formed corporation attained via step #2).
(4) As the new owner of the subsidiary shares, Mrs. Gregory sold them later on the same day.[14]

The liquidating distribution of the subsidiary's shares (step #3) was admittedly a taxable transaction, but only on the gain and at capital gains rates.[15] From the taxpayer's vantage point, however, all other aspects of the transaction were tax-free, shielded under a literal reading of the Code.[16]

The IRS disagreed, declaring that the reorganization was without substance and that Mrs. Gregory should be taxed as if she had received a dividend equal to the fair market value of the subsidiary's shares.[17] The Board of Tax Appeals thought otherwise, noting that the transaction was in literal compliance with the rules regarding reorganizations.[18] It therefore held that the transaction was to be respected and that dividend treatment was accordingly inappropriate.[19]

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12. *Id.*
13. *Id.*
14. *Id.*
15. I.R.C. § 331(a) (1934); I.R.C. § 331(a) (2018).
16. *Gregory*, 69 F.2d at 810 ("All these transactions being real, their purpose was irrelevant, . . . especially since it was part of a statute of such small mesh as the Revenue Act of 1928; the finer the reticulation, the less room for inference.").
17. *Id.*
18. *Id.*
19. Judge Hand's recapitulation of the Board of Tax Appeal's opinion is as follows:

On appeal, Judge Hand made it clear that taxpayers are entitled to structure transactions in the manner that exacts the gentlest tax bite.[20] As he framed it, "a transaction, otherwise within an exception of the tax law, does not lose its immunity, because it is actuated by a desire to avoid, or, if one choose, to evade, taxation. Any one may so arrange his affairs that his taxes shall be as low as possible."[21] But Judge Hand went on to observe that, to be respected, transactions have to be congruous with congressional intent.[22] He ultimately concluded that despite the taxpayer's literal compliance with the Code and its provisions covering tax-free reorganizations, this transaction did not constitute such an event and therefore failed to qualify for nonrecognition.[23] In other words, though the form of the transaction was a tax-free reorganization, the substance was not—and the latter controlled the tax consequences associated with the transaction.[24] With the imprimatur of this learned jurist,[25] this newly crafted formulation of the substance over form doctrine gained immediate respect within the legal community.[26]

> [T]he Board held that the Averill Corporation [(i.e., the newly-formed corporation)] had been in fact organized and was indubitably a corporation, that the United Mortgage Corporation [(i.e., the parent corporation)] had with equal certainty transferred to it the Monitor shares [(i.e., the shares of the subsidiary corporation)], and that the taxpayer had got the Averill shares as part of the transaction. All these transactions being real, their purpose was irrelevant, and section 112(i)(1)(B) was applicable [(i.e., the predecessor to the tax-reorganization provisions of Code section 368)].

Id.

20. *Id.*

21. *Id.* Notwithstanding these words, modern usage distinguishes (legal) tax avoidance from (illegal) tax evasion. For example, Code section 7201 makes any attempt to "evade or defeat any tax" a felony. I.R.C. § 7201 (2018).

22. *Gregory*, 69 F.2d at 811 ("To dodge the shareholders' taxes is not one of the transactions contemplated as corporate 'reorganizations.'"). The Supreme Court affirmed, finding that "[t]he whole undertaking, though conducted according to the [statutory] terms . . . was in fact an elaborate and devious form of conveyance masquerading as a corporate reorganization." Gregory v. Helvering, 293 U.S. 465, 470 (1935).

23. *Gregory*, 69 F.2d at 811.

24. *Id.* ("All these steps were real, and their only defect was that they were not what the statute means by a 'reorganization,' because the transactions were no part of the conduct of the business of either or both companies; so viewed they were a sham, though all the proceedings had their usual effect.").

25. *See generally* GERALD GUNTHER, LEARNED HAND: THE MAN AND THE JUDGE (2011).

26. Allen D. Madison, *The Tension Between Textualism and Substance-over-Form Doctrines in Tax Law*, 43 SANTA CLARA L. REV. 699, 700 (2003) ("Judge Learned Hand introduced these substance-over-form principles into tax law in 1934 in *Helvering v. Gregory*.").

A substantial body of tax jurisprudence has sprung from the *Gregory* case. To date, more than 1,000 cases have cited it.[27] What is fascinating is that the *Gregory* case sits perched atop two lines of authority that rely upon it for completely opposing reasons. On the one hand, taxpayers routinely reference it for the proposition that they are at liberty to try to minimize their tax burden;[28] on the other hand, the IRS regularly invokes it in order to defeat abusive transactions that exploit the Code's literal language.[29]

Over the course of the substance over form doctrine's long existence, it has achieved particular prominence in controlling abusive tax shelters.[30] No single comprehensive definition encompasses all forms of abusive tax shelters; however, such shelters are likely to be found "when a taxpayer reduces its tax liability by ordering its affairs in a manner that complies with the text of the statute but contradicts the intent of the law it purports to follow."[31] And while there are many reasons why the substance over form doctrine has gained such immense traction in income tax jurisprudence,[32] the amount of lost tax revenue associated with abusive tax shelters is surely one of the most compelling.[33]

27. Daniel N. Shaviro, *The Story of Knetsch: Judicial Doctrines Combating Tax Avoidance*, *in* TAX STORIES: AN IN-DEPTH LOOK AT TEN LEADING FEDERAL INCOME TAX CASES 313, 360 n.158 (Paul L. Caron ed., 2003).

28. *See Gregory*, 69 F.2d at 810 ("Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes.").

29. *See id.* at 811 ("All these steps were real, and their only defect was that they were not what the statute means by a 'reorganization,' because the transactions were no part of the conduct of the business of either or both companies; so viewed they were a sham, though all the proceedings had their usual effect."); *see also* Madison, *supra* note 26, at 700–01 ("In *Gregory*, Judge Hand held that a taxpayer who has jumped through the textual hoops in the Internal Revenue Code is not necessarily entitled to the tax benefit the text of the Code provides if the transaction or activities of the taxpayer appear questionable. Textualism and substance-over-form as applied in tax law are polar opposites. Under textualism, statutes should be interpreted on the basis of what the text means. Under the substance-over-form doctrines, courts are permitted to ignore or disregard the text of the Internal Revenue Code on the basis of economic principles or taxpayer motivation or both." (footnotes omitted)).

30. *See, e.g.*, Joseph Bankman, *The Economic Substance Doctrine*, 74 S. CAL. L. REV. 5, 5–6 (2000) ("For more than fifty years, courts have interpreted and applied the tax law with the aid of various 'common law' doctrines, such as substance over form, step transaction, business purpose, sham transaction, and economic substance.").

31. Orly Sulami, *Tax Abuse—Lessons from Abroad*, 65 SMU L. REV. 551, 558 (2012).

32. Isenbergh, *supra* note 9, at 863 ("Most major statutes raise problems of interpretation, of course, but the quest for 'substance' through the distracting haze of 'form' has attracted a particularly intense scrutiny in tax matters.").

33. The revenue loss associated with tax shelter activities has been significant. *See, e.g.*, Gabriel Zucman, *How Corporations and the Wealthy Avoid Taxes (and How to Stop Them)*, N.Y. TIMES (Nov. 10, 2017), https://www.nytimes.com/interactive/2017/11/10/opinion/gabriel-zucman

A remarkable feature of the substance over form doctrine is that the IRS has invoked it in a broad range of other diverse settings. Such settings include, but are not limited to, the issuance of putative annuity policies,[34] sale-leaseback arrangements,[35] and intrafamily loans.[36]

However, while the IRS has often prevailed by invoking the substance over form doctrine,[37] it is noteworthy that the agency's track record is imperfect,[38] largely because the substance of a transaction is often mutable or ambiguous.[39] Thus, simple utterance of the phrase *substance over form* does not allow the IRS to prevail merely by

-paradise-papers-tax-evasion.html [https://perma.cc/AC8Q-FT3M] ("Meanwhile, an estimated $8.7 trillion, 11.5 percent of the entire world's G.D.P., is held offshore by ultrawealthy households in a handful of tax shelters, and most of it isn't being reported to the relevant tax authorities."); Maria Tihin, *The Trouble with Tax Havens: The Need for New Legislation in Combating the Use of Offshore Trusts in Abusive Tax Shelters*, 41 COLUM. J.L. & SOC. PROBS. 417, 418 (2008) ("In 2006, it was estimated that Americans utilizing offshore entities have more than one trillion dollars in offshore assets and evade tax payments between forty and seventy billion dollars each year."); Noël B. Cunningham & James R. Repetti, *Textualism and Tax Shelters*, 24 VA. TAX REV. 1, 3 (2004) ("It is estimated that tax shelters reduced tax revenues by approximately $10 to $24 billion in 1999.").

34. *See, e.g.*, Knetsch v. United States, 364 U.S. 361, 366 (1960) (ruling that a purported annuity arrangement was a "sham" because "there was nothing of substance to be realized by [the taxpayer] . . . beyond a tax deduction").

35. *See, e.g.*, Rice's Toyota World, Inc. v. Comm'r, 752 F.2d 89, 95 (4th Cir. 1985) (noting that the taxpayer "did not purchase or lease a computer, but rather, paid a fee . . . for tax benefits").

36. *See, e.g.*, Zohoury v. Comm'r, 42 T.C.M. (CCH) 96, 98 (1981) ("A taxpayer is not entitled to deduct purported interest payments to a family member made with respect to loans in form if the purported loans are not loans in substance.").

37. It is almost invariably the case that it is the government that argues that substance should determine the outcome of a case rather than its form, for the simple reason that the taxpayer has already chosen to form the transaction in a way that will generate the hoped-for favorable tax treatment. However, see *supra* text accompanying note 4.

38. Consider two representative cases. First, in *Frank Lyon Co. v. United States*, 435 U.S. 561, 561 (1978), despite IRS objections that the transaction in question constituted a mere financing arrangement rather than a property purchase, the Supreme Court allowed depreciation deductions—which are, of course, premised on ownership of the asset—for the taxpayer. Likewise, in *Compaq Computer Corp. v. Commissioner*, 277 F.3d 778, 785, 788 (5th Cir. 2001), the U.S. Court of Appeals for the Fifth Circuit disagreed with the IRS's argument that because the taxpayer did not bear the burden of the foreign tax, the taxpayer wasn't entitled to foreign tax credits being claimed; instead, the court focused on the fact that the taxpayer's ownership interest gave rise to "both a reasonable possibility of profit attended by a real risk of loss and an adequate non-tax business purpose." *Id.* at 788.

39. *See* Marvin A. Chirelstein & Lawrence A. Zelenak, *Tax Shelters and the Search for a Silver Bullet*, 105 COLUM. L. REV. 1939, 1948 (2005) (recognizing "the ambiguous and untrustworthy application of the economic substance doctrine"); Bankman, *supra* note 30, at 11 ("Litigation involving the economic substance doctrine involves related, but in some sense distinct, litigation over the text, intent, and purpose of the statute. The precise relationship between the economic substance doctrine and conventional statutory interpretation is ambiguous.").

referencing it.[40] Rather, the phrase constitutes an invitation to analysis, following which the court in question will reach its own conclusions.

III. TRANSFER TAX ADJUDICATIONS: APPLICATION OF THE DOCTRINE GOES MISSING

As noted, as a beacon designed to shed light, the substance over form doctrine has played a critical role in the income tax realm, enabling courts to patrol against those things that masquerade as something that they are not, protecting the income tax base, and safeguarding the sanctity of the government's coffers.[41] Oddly, this sensitivity to a transaction's substance rather than its form appears to be less evident, or in any event much less successful, in constraining abusive transfer tax schemes. Three representative families of transactions—(A) irrevocable life insurance trusts, (B) family limited partnerships, and (C) upstream transfers[42]—illustrate this puzzling phenomenon. Each is explained below.

A. Irrevocable Life Insurance Trusts

Life insurance proceeds payable to a decedent's estate or beneficiaries are generally includable in one's gross estate if the decedent retained "incidents of ownership" in the insurance policy.[43] Incidents of ownership generally include the right to designate beneficiaries, surrender the policy for its cash value, or borrow against the cash value

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40. *See, e.g.*, Johnson v. Comm'r, 495 F.2d 1079, 1082 n.5 (6th Cir. 1974) ("The 'substance over form' argument is not a magic incantation which makes a transaction tax-exempt at a taxpayer's command (or taxable at the Commissioner's wish)."); Harris v. Comm'r, 61 T.C. 770, 783 (1974) ("But a mere incantation of 'substance versus form' and 'step transaction' does not transform a transaction with one set of tax consequences into a transaction with different tax consequences."); Yates Holding Corp. v. Comm'r, 39 T.C.M. (CCH) 303, 307 (1979) ("'Substance over form' is not a talismanic incantation that will transform or recast an event. Rather, it is a doctrine which depends upon the presentation of facts sufficient in quantity and quality to establish the 'true nature of a transaction' and strip away the disguise of 'mere formalisms, which exist solely to alter tax liabilities.'").

41. *See, e.g.*, Isenbergh, *supra* note 9, at 870 ("Subsequent decisions have found in *Gregory* a broad mandate to attack perceived 'bad' features of transactions, however firmly anchored within the terms of the Code.").

42. *Upstream* refers to the somewhat unnatural phenomenon of gifts given from a younger person to an older one (e.g., parent or grandparent), in contrast to the usual practice of an older person making gifts to a younger person (e.g., child or grandchild). *See* Jonathan Curry, *TCJA Supercharges 'Upstream' Estate Tax Planning Techniques*, 158 TAX NOTES 1845, 1845 (2018) (defining upstream).

43. I.R.C. § 2042 (2018).

of the policy.[44] This inclusion rule is important because, without it, it would be possible to strip an estate of much of its value yet still maintain economic control over features that can readily function as a testamentary substitute.[45]

But for more than five decades, an important loophole to this life insurance inclusion rule has existed.[46] If a taxpayer establishes an irrevocable trust over which no control is retained and that either (i) purchases a new life insurance policy on the taxpayer's life or (ii) receives an existing life insurance policy,[47] a taxpayer can keep the death benefits from the policy out of her gross estate.[48] In addition, the subsequent annual life insurance premiums can be paid by the taxpayer without incurring any gift tax exposure because the so-called annual exclusion (currently equal to $16,000 per donee) may shelter such trust contributions from gift tax.[49] This situation can extend for as long as the taxpayer lives, enabling thousands, even millions of dollars of trust contributions (plus the earnings that the insurance company will credit over that period to the policy) to escape the gift tax base.[50] Such

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44. Treas. Reg. § 20.2042-1(c)(2) (2020) ("For purposes of this paragraph, the term 'incidents of ownership' is not limited in its meaning to ownership of the policy in the technical legal sense. Generally speaking, the term has reference to the right of the insured or his estate to the economic benefits of the policy. Thus, it includes the power to change the beneficiary, to surrender or cancel the policy, to assign the policy, to revoke an assignment, to pledge the policy for a loan, or to obtain from the insurer a loan against the surrender value of the policy, etc.").

45. Absent this rule, taxpayers could diminish their estates by the amount of the premiums paid plus earnings that those amounts might have generated, even though those values will continue to be among the wealth transferred at death.

46. Beginning in 1918, under the prior rule, insurance "taken out by the decedent upon his own life" and payable either to his estate or named beneficiaries was includable in the decedent's gross estate. Revenue Act of 1918, § 402(f), 40 Stat. 1057, 1098 (1918). However, Congress subsequently limited the application of this broad rule. *See* Revenue Act of 1942, Pub. L. No. 77-753, § 404(a), 56 Stat. 798, 944 (1942) (essentially limiting estate tax inclusion to those instances when taxpayers retain any indicia of control).

47. In the latter case, if the policy being transferred already has cash surrender value, this would ordinarily be regarded as a gift to the trust beneficiaries that would be subject to gift tax. *See* I.R.C. § 2501 (2018). For reasons that are explained in the next two paragraphs, utilization of the taxpayer's annual exclusion found under I.R.C. § 2503(b) (2018) often shelters such trust contributions from any gift tax exposure.

48. *See, e.g.*, Adam L. Abrahams, *Irrevocable Life Insurance Trusts: An Effective Estate Tax Reduction Technique*, PRAC. TAX LAW., Summer 2013, at 35, 36 (2013) ("An ILIT removes the life insurance proceeds from the gross estate of a decedent, thus reducing one's taxable estate.").

49. *See* I.R.C. § 2503(b) (2018). Thus, a married taxpayer who has two daughters, two sons-in-law, and four grandchildren could make all of the foregoing family members trust beneficiaries. In such a case, the married couple can "split" such gifts (I.R.C. § 2513 (2018)), enabling up to $256,000 of contributed value annually to escape the gift tax base (i.e., for annual exclusion purposes, in the case of married couples, there is currently an effective $32,000 per beneficiary limit).

50. *See* David C. Johnson, *Cumulation of Lifetime Gifts in the Federal Estate Tax Computation*, 1984 S. ILL. U. L.J. 283, 287–88 ("This is because: the annual exclusion escapes both gift and

trust contributions can produce a generously funded policy, which in turn can yield a substantial death benefit that will escape the estate tax base.[51] And if a taxpayer's so-called generation-skipping transfer tax exemption is allocated to the annual trust contributions,[52] the insurance proceeds can cascade down multiple generations and escape the generation-skipping transfer tax base as well.

But to qualify for the annual exclusion (upon which this arrangement depends), the gifts in question must be of a "present interest."[53] Gifts in trust do not routinely so qualify for this exclusion; instead, they ordinarily constitute future interests (i.e., they vest at a later point in time).[54] In the 1960s, in order to create a colorable present interest, creative estate planners conceived of the following simple two-step process: (i) with respect to any trust contribution, give designated beneficiaries the right to demand distributions of those amounts during a limited period of time; (ii) if the trust beneficiaries fail to make such demands within the allotted time frame, their invasion right will lapse, leaving the contributed assets inside the trust, where they can be used to pay insurance premiums.[55]

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estate tax computations; the gift tax computation is based on the net amount transferred; the appreciation from the gifted property is removed; the payment of gift tax itself depletes the estate; and, to the extent income is shifted, the income is removed from the estate tax base." (footnotes omitted)).

51. *See* Harry L. Gutman, *Reforming Federal Wealth Transfer Taxes After ERTA*, 69 VA. L. REV. 1183, 1245 n.179 (1983) ("This decrease in progressivity occurs because the tax-free [annual exclusion] gift removes from the tax base property that would be taxed at the highest applicable marginal rate if retained.").

52. *See* I.R.C. § 2631 (2018).

53. *See id.* § 2503(b) ("In the case of gifts (other than gifts of future interests in property) . . . ."). Treasury Regulations define *future present* and *present interest* as follows:

> "Future interest" is a legal term, and includes reversions, remainders, and other interests or estates, whether vested or contingent, and whether or not supported by a particular interest or estate, which are limited to commence in use, possession, or enjoyment at some future date or time. . . .
>
> An unrestricted right to the immediate use, possession, or enjoyment of property or the income from property (such as a life estate or term certain) is a present interest in property.

Treas. Reg. § 25.2503-3(a)–(b) (as amended in 1983).

54. *See, e.g.*, John G. Steinkamp, *Common Sense and the Gift Tax Annual Exclusion*, 72 NEB. L. REV. 106, 123 (1993) ("Gifts in trust, however, do not necessarily result in allowance of the annual exclusion. A gift in trust may result in the transfer of many equitable interests to many beneficiaries. Because of the many ways in which gifts may be made in trust, no simple rule exists for determining whether such a gift is of a present or future interest." (footnotes omitted)).

55. *See* Robert B. Smith, *Should We Give Away the Annual Exclusion?*, 1 FLA. TAX REV. 361, 388 (1993).

> As a means of satisfying the present interest requirement in connection with transfers in trust, taxpayers' advisors developed plans which gave the trust beneficiaries withdrawal rights with respect to property transferred to the trust. The trust beneficiary or

To illustrate, suppose A is married to B and they have four children, C, D, E, and F. Suppose further that A establishes an irrevocable trust that buys a $5 million life insurance policy on his life with annual premiums of $135,000, whose terms contain a 30-day withdrawal power. Each year, A contributes the sum of $135,000 to the trust and the trustee of the trust informs B that she has the right to make a trust withdrawal of $15,000 and informs C, D, E, and F that they each have the right to make a trust withdrawal of $30,000.[56] After the 30-day window lapses, and assuming that B, C, D, E, and F fail to exercise their trust withdrawal rights, the trustee may use the contributed trust funds to pay the life insurance premium that is due. Without utilizing a dime of his lifetime exemption amount, A can continue to make annual trust contributions for years or decades to come until he passes away, and the trust will receive the $5 million death benefit.

Although the technique is dubious, the U.S. Court of Appeals for the Ninth Circuit in *Crummey v. Commissioner*[57] endorsed the withdrawal technique as complying with the annual exclusion requirement,[58] after which these invasion powers were eponymously dubbed "Crummey withdrawal powers."[59] In practice, the grant of a Crummey withdrawal power is illusory. Several factors lead to that conclusion: If the holder of the power is a minor, the power would be exercised—or, in actuality, not exercised—by the minor's parent or guardian;[60] the period during which the invasion option can be exercised may be

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> beneficiaries are granted a right, exercisable with respect to property transferred into the trust and for a limited period of time following the transfer, such as 30 days, to withdraw an amount equal to the lesser of: (i) a pro rata share of the property contributed to the trust; or (ii) the annual exclusion. Such withdrawal rights give each beneficiary an unrestricted right, upon their demand, to use or enjoy the amount subject thereto.

Id.

56. With respect to the children, A and B can make so-called split gifts so that each may be deemed to have made a gift of one-half each. *See* I.R.C. § 2513(a)(1) (2018).

57. 397 F.2d 82 (9th Cir. 1968).

58. *Id.* at 88.

59. *See* Dora Arash, Comment, *Crummey Trusts: An Exploitation of the Annual Exclusion*, 21 PEPP. L. REV. 83, 92 (1993) ("To avoid the unfavorable tax consequences of such transfers, practitioners have developed an ingenious device that qualifies a transfer as a present interest while permitting the deferral of distribution to the intended beneficiary. The device employed by estate planners to avoid the adverse tax consequences of an inter vivos transfer is known as a Crummey Trust.").

60. An IRS Revenue Ruling and several private letter rulings support this position and indeed go a step further: if there is no natural guardian to the minor but one could be court appointed, the minor's Crummey withdrawal right qualifies for the annual exclusion. *See* Rev. Rul. 73-405, 1973-2 C.B. 321; I.R.S. Priv. Ltr. Rul. 8143045 (July 29, 1981); I.R.S. Priv. Ltr. Rul. 8121069 (Feb. 26, 1981).

quite brief;[61] and it is even unclear whether the beneficiaries need to be notified of the existence of their right of invasion.[62]

Thus, as a practical matter, it is exceedingly rare that Crummey withdrawal powers are exercised.[63] Yet, the barest possibility that they might be is the concept that makes irrevocable insurance trusts useful in estate planning.[64] In early cases, including *Crummey* itself, the IRS questioned the legitimacy of this planning device, for good reason: while the form of the contribution technically met the specified Code requirements of being a present interest, the substance of the transaction strongly suggested that the taxpayer's true objective was to have the trust funds vest years or decades later (an anathema for gift tax annual exclusion qualification).[65]

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61. For example, in *Estate of Cristofani v. Commissioner*, 97 T.C. 74, 84 (1991), the Tax Court held that the fifteen-day period involved in that case was sufficient.

62. *See* I.R.S. Priv. Ltr. Rul. 9030005 (Apr. 19, 1990) (ruling that a trustee need not send a Crummey notice to himself); Est. of Turner v. Comm'r, 102 T.C.M. (CCH) 214, 229 (2011) (allowing indirect trust gifts (i.e., grantor's direct payments of premiums on a trust-owned policy to the carrier) to qualify for the annual exclusion, even though the trustee did not provide notice to the trust beneficiaries of their withdrawal rights in these indirect gifts).

63. *See generally* Bradley E.S. Fogel, *The Emperor Does Not Need Clothes—The Expanding Use of "Naked"* Crummey *Withdrawal Powers to Obtain Federal Gift Tax Annual Exclusions*, 73 TUL. L. REV. 555 (1998) (explaining why beneficiaries rarely, if ever, exercise their withdrawal rights).

The concept of a so-called naked Crummey right is interesting in and of itself. Usually, when a Crummey right lapses, the beneficiary retains a vested interest in the trust corpus (which, as a product of such lapse, now grows larger). *Id.* at 559. But this need not be the case; in other words, taxpayers may grant a Crummey right to a person who has no future interest in the trust corpus. *Id.* at 570. As observed by one commentator, a naked Crummey right is "a lapsing demand right without any corresponding interest in the corpus of the trust." Patrick T. Neil, *"Bare"ly Legal: The Evolution of Naked Crummey Powers and a Call for Reform*, 30 FLA. ST. U. L. REV. 923, 938 (2003). The same commentator added, "With naked Crummey powers, the beneficiary has no conceivable economic incentive to allow a lapse to occur because once the demand power has lapsed, the income from that demand right is gone forever." *Id.* In *Estate of Cristofani*, 97 T.C. 74 (1991), for example, the Tax Court sanctioned the taxpayer's use of semi-naked Crummey powers extending to the taxpayer's grandchildren who only had a contingent interest in the trust, predicated upon their parents predeceasing them. *Id.* at 83.

64. Fogel, *supra* note 63, at 617 ("There is, however, nothing unique to a naked *Crummey* power [(i.e., a beneficiary who has only a remote trust interest)], in and of itself, that renders it invalid. While the use of naked *Crummey* powers is, without question, artificial, all *Crummey* powers are artificial and the distinctions drawn between naked and other *Crummey* powers lack substance.").

65. *See* Kristin L. Zook, Note, *A Not-So-*Crummey *Way to Avoid Taxes: A Call for Congressional Action to Eliminate Abuse of the Present Interest Requirement*, 58 SYRACUSE L. REV. 583, 585–86 (2008) ("Further, those who do *not* qualify without *Crummey*'s expanded interpretation, but nonetheless are granted exclusions under the *Crummey* rationale, are in effect abusing the benefit and becoming entitled to exclusions that they would otherwise be denied. This abuse by *Crummey* powers is not parallel with Congress' original intention behind the enactment of the federal gift tax and the annual exclusion.").

After several years of judiciary pushback, which never seriously entertained the application of the substance over form doctrine in this context, the IRS has acquiesced to this outcome.[66] While it seems that the agency would be free to reconsider its position, it is more likely that congressional action would now be required to close this loophole.[67]

B. Family Limited Partnerships

In a family limited partnership situation, a commonplace scenario is as follows: a wealthy taxpayer establishes a limited partnership; contributes property to this enterprise; and then distributes partnership interests to her family members, in varying proportions according to the taxpayer's preferences.[68]

This simple arrangement can produce significant transfer tax savings. Because the partnership interests in question are not traded on a public market, a valuation discount is available for their lack of marketability; furthermore, because the interests accorded to family members are strategically made below 50 percent, their status permits minority discounts.[69] The combination of marketability and minority

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66. *See* Crummey v. Comm'r, 25 T.C.M. (CCH) 772 (1966), *action on dec.*, 1966-144 (Aug. 23, 1966) ("Further litigation of this issue is unwarranted. The Service accepts the view that gifts in trusts for minors under circumstances similar to the instant case should not be classified as future interests merely because no guardian was in fact appointed as long as the trust provides for such appointment and no legal impediment under local law exists.").

67. Due to the natural limitations related to the size of the annual exclusion, this device has primarily been used by medium-sized estates, in the $5 million to $25 million range. However, given the size of the current lifetime exemption ($12,060,000), estates of this size are now largely beyond the reach of the current transfer tax system. Rev. Proc. 2021-45, § 3.41, 2021-48 I.R.B. 764, 771. As a result, this device holds less appeal to estate planners unless or until the lifetime exclusion is decreased to levels more in keeping with the historical purpose of transfer taxes. *See* Jay A. Soled, *The Federal Estate Tax Exemption and the Need for Its Reduction*, 47 FLA. ST. U. L. REV. 649 (2020) (observing that the lifetime exemption is too high and, as such, subverting the historic purposes of the nation's transfer tax regime).

68. *See, e.g.*, Troy Renkemeyer, Comment, *The Family Limited Partnership: An Effective Estate Planning Tool*, 64 UMKC L. REV. 587, 587–92 (1996) (extolling the virtues of family limited partnerships as a device to minimize transfer tax exposure).

69. *See* Ronald H. Jensen, *The Magic of Disappearing Wealth Revisited: Using Family Limited Partnerships to Reduce Estate and Gift Tax*, 1 PITT. TAX REV. 155, 155 (2004) ("Medieval alchemists strived to transmute base metals into gold. Today, taxpayers seek a reverse transmutation: to reduce the value of their property—at least when it is being valued for gift and estate tax purposes."); D. John Thornton & Gregory A. Byron, *Valuation of Family Limited Partnership Interests*, 32 IDAHO L. REV. 345, 361–71 (1996) (explaining how taxpayers can camouflage the fair market value of the partnership interests that they transfer); Mary Louise Fellows & William H. Painter, *Valuing Close Corporations for Federal Wealth Transfer Taxes: A Statutory Solution to the Disappearing Wealth Syndrome*, 30 STAN. L. REV. 895, 903–21 (1978) (describing marketability and minority discounts).

interest discounts, combined with the use of the gift tax annual exclusion, can shield large partnership interest transfers from gift tax exposure.[70] Indeed, common valuation discounts can range from 10 percent to 70 percent and remain available even when the contributed partnership assets consist mostly of securities that are themselves readily marketable.[71]

To illustrate, assume that a taxpayer establishes a family limited partnership with her husband and that together they contribute a jointly owned building worth $1 million. Assume further that a week later they each give their daughter a 24 percent partnership interest. For gift tax purposes, rather than the transferred partnership interest being valued at $240,000 (i.e., 24% x $1 million), the taxpayers could conservatively take a combined 40 percent minority and marketability valuation discount and instead report making a taxable gift of $144,000 (i.e., 24% x $1 million x (1 - 0.4)).

Of course, to believe that contributing assets to a family limited partnership and then transferring such partnership interests inherently reduces the fair market value of the contributed assets is silly on its face. No rational taxpayer would vandalize her own assets in a manner that purposely diminishes their value.[72] Instead, the taxpayers are using a form—namely, a family limited partnership—to camouflage the substance of what they are seeking to achieve, which is to enrich younger family members with minimal transfer tax exposure. Once the family limited partnership is in place, family members can easily cooperate to maximize the value that each would receive were the partnership assets or its interests sold or liquidated. The asset value, in other words, isn't truly destroyed; it is merely temporarily marred,

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70. *See, e.g.*, Thomas E. Rutledge & Lady E. Booth, *The Limited Liability Company Act: Understanding Kentucky's New Organizational Option*, 83 KY. L.J. 1, 116 (1995) ("If the LLC has continuity of life, then annual exclusion gifts may be facilitated, and reduction in value may result from the lack of marketability and minority interest discounts.").

71. *See, e.g.*, Est. of Kelley v. Comm'r, 90 T.C.M. (CCH) 369, 371, 374 (2005) (according significant discounts for the interests that the taxpayers transferred in a case involving a family limited partnership the assets of which consisted solely of cash and certificates of deposit); *see also* Wendy C. Gerzog, *Valuation Discounting Techniques: Terms Gone Awry*, 61 TAX LAW. 775, 789–91 (2008) (citing range of discounts and describing a litany of cases involving this commonplace phenomenon).

72. *See* Samuel A. Donaldson, *Super-Recognition and the Return-to-Sender Exception: The Federal Income Tax Problems of Liquidating the Family Limited Partnership*, 35 CAP. U. L. REV. 15, 15–16 (2006) ("The Internal Revenue Service (Service) sees the family limited partnership as an elaborate shell game designed to artificially destroy value and, thus, unfairly reduce the federal gift tax or federal estate tax liability associated with wealth transfers.").

subject to later cleanup and restoration when it is convenient from a tax viewpoint.[73]

A quick review of the dynamics of family limited partnerships reveals their true essence. They are nothing more than devices to diminish value on a temporary basis.[74] Putting aside the vicissitudes of business and economic cycles, it would seem that virtually no one has ever lost a dollar by entering into these arrangements. Yes, misguided family members could turn against one another; but the far more likely scenario is that, consistent with their collective financial self-interest, they will all work together to maximize value.[75]

Family limited partnerships would thus seem fertile grounds for the IRS to invoke the substance over form doctrine, and one might think that courts would be receptive to the agency's efforts to do so. But after some important initial failures to persuade the courts,[76] the IRS has largely abandoned its effort to draw the line at the point where no discounts would be allowed,[77] settling instead for occasional

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73. *See* Joseph M. Dodge, *Redoing the Estate and Gift Taxes Along Easy-to-Value-Lines*, 43 TAX L. REV. 241, 254 n.54 (1988) ("Of course, in many of these cases, the economic loss attributable to the creation of minority interests is probably illusory, or else the transaction would not have been undertaken in the first place.").

74. *See* Joseph M. Dodge, *Three Whacks at Wealth Transfer Tax Reform: Retained-Interest Transfers, Generation-Skipping Trusts, and FLP Valuation Discounts*, 57 B.C. L. REV. 999, 1029 (2016) ("Three facts offer strong circumstantial evidence that FLPs (and similarly constituted entities) are primarily motivated to save transfer taxes. First, the claimed purpose of destroying family wealth, if correct, is irrational. Second, FLPs were not discernable in the commercial landscape until their gift/estate tax benefits were publicized. Third, FLPs are exclusively used by wealthy individuals facing estate tax exposure." (footnote omitted)).

75. *See* Laura E. Cunningham, *Remember the Alamo: The IRS Needs Ammunition in Its Fight Against the FLP*, 86 TAX NOTES 1461, 1466 (2000) (discussing that a family attribution approach has been attempted to eliminate the problem of disappearing value from minority interest discounting under the "theory . . . that minority discounts lack economic reality . . . because the family is more likely than not to cooperate"). Furthermore, at the time of partnership formation, familial relationships presumably were amicable or the taxpayer might not have seen the family limited partnership as a promising estate tax–avoidance vehicle.

76. Key valuation adjudication cases in which courts ruled against the IRS and permitted steep valuation discounts include the following: *Estate of Bright v. United States*, 658 F.2d 999 (5th Cir. 1981); *Propstra v. United States*, 680 F.2d 1248 (9th Cir. 1982); *Estate of Andrews v. Commissioner*, 79 T.C. 938 (1982); and *Estate of Lee v. Commissioner*, 69 T.C. 860 (1978).

77. *See* Rev. Rul. 93-12, 1993-1 C.B. 202, 1993 WL 15534, where the IRS has held thus:

> If a donor transfers shares in a corporation to each of the donor's children, the factor of corporate control in the family is not considered in valuing each transferred interest for purposes of section 2512 of the Code. For estate and gift tax valuation purposes, the Service will follow Bright, Propstra, Andrews, and Lee in not assuming that all voting power held by family members may be aggregated for purposes of determining whether the transferred shares should be valued as part of a controlling interest. Consequently, a minority discount will not be disallowed solely because a transferred interest, when aggregated with interests held by family members, would be a part of a controlling interest.

challenges to family partnership arrangements on the basis that particular discounts are excessive[78] or that the transfers themselves are ineffective.[79]

C. Upstream Transfers

Both Crummey withdrawal powers and family limited partnerships have been around for several decades. One might even say that they are now scourges that have been inked into the estate planners' playbook. But there is a new technique coming into vogue that is just as egregious, commonly known as "upstream gifting" (a.k.a. "upstream transfers").[80] The technique involves the process of making transfers from a younger generation to members of an older one—generally those who have relatively short remaining life expectancies.[81]

The surge of interest in such transfers can be traced to the Tax Cuts and Jobs Act of 2017,[82] which doubled the basic exclusion amount from $5 million to $10 million.[83] The size of the current exemption effectively eliminates many taxpayers' transfer tax exposure. As such, taxpayers are now at liberty to transfer during life and upon

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> This would be the case whether the donor held 100 percent or some lesser percentage of the stock immediately before the gift.

Id. at *2.

78. *See* Alden Koste, Note, *The IRS Fished Its Wish: The Ability of Section 2703 to Minimize Valuation Discounts Afforded to Family Limited Partnership Interests in* Holman v. Commissioner, 59 CATH. U. L. REV. 289, 294–305 (2009) (discussing cases in which the IRS has taken the position that the valuation discount was excessive).

79. *See, e.g.*, Est. of Abraham v. Comm'r, 408 F.3d 26, 28 (1st Cir. 2005) (holding that money in family limited partnerships established by the children of elderly taxpayer with Alzheimer's disease was, due to taxpayer's retained interest, includable in her gross estate); Est. of Erickson v. Comm'r, 93 T.C.M. (CCH) 1175, 1182 (2007) (ruling that transfer of property shortly before decedent died indicated that she had a retained interest in the property); Est. of Rosen v. Comm'r, 91 T.C.M. (CCH) 1220, 1232 (2006) (same).

80. This Article refers to "upstream gifts" as "upstream transfers" because the authors don't perceive such gifts as true gifts; however, the vernacular of the trade is to call them *gifts*. *See, e.g.*, Curry, *supra* note 42, *passim*; Karen Hube, *An Old Tax Dodge for the Wealthy Is Making a Comeback*, BARRON'S (May 7, 2019), https://www.barrons.com/articles/upstream-planning-tax-dodge-51556918447 [https://perma.cc/B96K-8HJR]; Lester B. Law & Howard M. Zaritsky, *Basis After the 2017 Tax Act—Important Before, Crucial Now*, HECKERLING INST. ON EST. PLAN. 110 *passim* (2019).

81. As a scientist might note, these are transactions that are not observed in nature. And they are indeed often most unnatural: what could be the point of making a gift of property having a six-, seven-, or eight-figure value to an elderly relative who is largely or entirely confined to a nursing home?

82. Tax Cuts and Jobs Act of 2017, Pub. L. No. 115-97, § 11061, 131 Stat. 2054, 2091 (2017).

83. These are the statutory exclusion amounts, but they are adjusted for inflation annually. I.R.C. § 2010(c)(3)(B) (2018). For decedents dying in 2022, or gifts made in that year, the exclusion is $12,060,000. Rev. Proc. 2021-45, § 3.41, 2021-48 I.R.B. 764, 771. In the case of a married couple, this can be effectively doubled to $24,120,000. I.R.C. § 2010(c)(4) (2018).

death all or most of their estates absent the friction of transfer tax liability. In light of this new transfer tax landscape, creative tax planners have significantly expanded the use of "upstream planning"—a scheme that conforms to the Code's literal dictates yet is substantively vacant. But if history is any barometer, it is unlikely to be successfully challenged by the IRS.

A simple example that captures the essence of upstream planning follows. Suppose a wealthy taxpayer who owns title to a highly appreciated asset (perhaps a building with a zero tax basis but a fair market value of $10 million) transfers title to the building to his 90-year-old widowed mother, who has a $1 million net worth. Son expects, and Mother understands, that upon her demise she will give the building back to Son.[84] Why would a wealthy taxpayer ever make such a transfer? Because when the son inherits the property from his mother, the application of Code section 1014 will accord a tax basis in the building equal to its fair market value at the date of his mother's death.[85] The augmented tax basis would produce significant future income tax savings in the form of robust depreciation deductions or, upon the disposition of the building, smaller gains or larger losses than he would have incurred had the proverbial angel of Code section 1014 not passed over them.

This scheme is not entirely free of risk. Mother might fall in love with the next Don Juan who checks into her nursing home, she might discover religion and seek to leave the entirety of her assets to a local church, another relative could fall ill and seem to Mother a more deserving heir, or Mother and Son could simply have a falling out. Furthermore, if Mother perishes within one year of the initial title transfer, the basis-equal-to-fair-market-value rule will not apply.[86] (This last scenario isn't much of a risk, however, as it leaves Son no worse off than if he hadn't made the transfer to Mother at all.)[87]

84. For heuristic reasons and to keep the illustration simple, Mother gave title to the building directly back to Son outright. However, for transfer tax purposes, this outcome does not make sense (i.e., it unnecessarily augments the size of the son's gross estate), and most estate planners have developed sophisticated planning techniques to minimize this concern. *See infra* note 87.

85. I.R.C. § 1014(a) (2018).

86. *Id.* § 1014(e).

87. But it means that some transaction costs will have been incurred to no useful end. In addition, having utilized $10 million of his lifetime exemption by making the initial transfer, Son may expose himself to future transfer tax consequences unnecessarily. The risk spectrum is serious enough that a more elaborate upstream planning strategy has emerged. Instead of a simple outright transfer to Mother, Son may establish an irrevocable trust for her benefit, the salient terms of which would include a testamentary general power of appointment. Son would then contribute title to the

Upstream planning of the sort described is financially attractive to Son and harmless to Mother. Indeed, only the government suffers by collecting less in both income and transfer taxes.[88] One could imagine that the IRS would claim that these transactional charades should be accorded no respect because they are not, in substance, gifts at all. After all, upstream transfers have virtually none of the usual characteristics of a traditional gift. On several occasions, the Supreme Court has spoken about those characteristics. In *Commissioner v. LoBue*,[89] the Court observed that a gift proceeds from a "detached and disinterested generosity."[90] In *Commissioner v. Duberstein*,[91] the Court declared that the character of the transaction should be determined by "the dominant reason that explains [the transferor's] action in making the transfer."[92] And in *Bogardus v. Commissioner*,[93] the Court added that a transfer would not be a gift if the transfer stems from "the incentive of [future] anticipated benefit[s to the transferor]."[94]

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building to the trust, rather than making an outright gift to Mother. If, as expected, Mother does not exercise the general power of appointment—the mere presence of which causes the desired estate tax inclusion (I.R.C. § 2041(a)(2) (2018))—then title to the building would flow in further trust for the benefit of Son's children/grandchildren. (Mother may allocate her generation-skipping transfer exemption to the trust (I.R.C. § 2631(a) (2018)) to safeguard its proceeds from generation-skipping transfer tax exposure.) Finally, Son may appoint a friendly party such as his spouse as the trustee. If Son follows the foregoing steps (and Mother willingly acquiesces), he greatly diminishes the risk that the building will slip out of his family's control; furthermore, he eliminates future estate tax inclusion of such property in his own estate.

88. The reason that the government loses income tax revenue is rather obvious from the application of the stepped-up basis rule. I.R.C. § 1014(a) (2018).

The reason the government loses transfer tax revenue is somewhat less obvious. To illustrate this point, consider the following example and assume that the estate tax exemption and generation-skipping transfer tax exemption are each $10 million. Suppose Son, whose net worth is $30 million, transfers $10 million of appreciated assets to his Mother (who, prior to such transfer, was penniless). Suppose further that two years later, Son's Mother dies, establishing a lifetime trust for the benefit of her son's children (namely, her grandchildren), which ultimately vests with her great-grandchildren and which, by the allocation of her generation-skipping transfer tax exemption, would be protected from any future estate tax. By making this transfer to his Mother, Son is thus able to exploit the use of her generation-skipping transfer tax exemption. Indeed, had the Son not engaged in this upstream transfer, the total amount the Son would have been able to pass tax-free to his grandchildren, namely, his Mother's great-grandchildren, would have been $10 million; going through the upstream exercise enables the amount passing transfer tax-free to double to $20 million.

89. 351 U.S. 243 (1956).

90. *Id.* at 246.

91. 363 U.S. 278 (1960).

92. *Id.* at 286.

93. 302 U.S. 34 (1937).

94. *Id.* at 41.

None of these descriptions support characterizing upstream transfers as gifts. Such transfers are made with the expectation of a future financial benefit inuring to the initial transferor, not the recipient of such property; they do not proceed from detached and disinterested generosity; and, without doubt, the dominant motivation underlying such transfers is to reduce the transferor's taxes rather than to enrich the recipient.

Estate planners will be quick to point out that the three Supreme Court decisions cited above are all income tax cases and that there is a general interpretive principle that such cases are not regarded as *in pari materia* with estate and gift tax cases.[95] This is entirely sensible, and nowhere more so than in defining what constitutes a gift:

(i) due to their exclusion under Code section 102, for income tax purposes, gifts are effectively removed from the tax base, and, accordingly, a narrow understanding of the word *gift* is essential to protect the fisc;[96]

(ii) but for gift tax purposes, gifts *are* the tax base,[97] and therefore it follows that the gift concept should be construed much more expansively.[98]

However, notwithstanding the supposed breadth of the word *gift*,[99] there is a commonsense notion of what it means. And there would likely be unanimity that it does not mean a pseudo transfer that moves bare legal title temporarily (with 366 days being the ideal duration), following which the "gift" reverts back either directly to the transferor or to his designees. That is the animating idea of upstream transfers, and it doesn't square well with anyone's concept of a gift. The central idea of a gift, for either income or gift tax purposes, is a

95. Cummings v. Comm'r, 506 F.2d 449, 454 (2d Cir. 1974); Early v. Comm'r, 445 F.2d 166, 172 (5th Cir. 1971); McGinnis v. Comm'r, 65 T.C.M. (CCH) 1870, 1873 (1993); Towe v. Comm'r, 64 T.C.M. (CCH) 1424, 1426 (1992). Several commentators disagree and think that the income and transfer tax systems should be read *in pari materia*. Mark J. Wolff, Dickman *Confined: The Taxation of Gratuitous Transfers of Use*, 21 STETSON L. REV. 509, 512 (1992); *see* Erwin N. Griswold, *A Plan for the Coordination of the Income, Estate, and Gift Tax Provisions with Respect to Trusts and Other Transfers*, 56 HARV. L. REV. 337 (1942).

96. Marjorie E. Kornhauser, *The Constitutional Meaning of Income and the Income Taxation of Gifts*, 25 CONN. L. REV. 1, 1–2 (1992).

97. I.R.C. § 2502(a) (2018).

98. *Id.* § 2511(a).

99. *Id.*; *see id.* § 2501(a) ("A tax, computed as provided in section 2502, is hereby imposed for each calendar year on the transfer of property by gift during such calendar year by any individual resident or nonresident.").

voluntary transfer from a donor for the benefit of the donee.[100] If the obvious intent of the transfer is to create a direct or indirect benefit for the donor, the transfer simply doesn't comport with the notion of a gift.

Furthermore, it is important to note that although this at first may seem like a gift tax question because there may be an obligation to file a gift tax return,[101] it really isn't. An important premise of the upstream transfer model is that, notwithstanding an obligation to file a gift tax return, there is no meaningful risk that there will be any transfer tax liability associated with such transfers: the transferor and the recipient will each be confident that the lifetime exclusion amount will shield their respective transfers from any transfer tax exposure.[102]

So, in the end, the upstream transfer story is really anchored in the income tax. The goal is to use—*abuse* is perhaps a better word—the stepped-up basis rule of Code section 1014. If and when transactions of the sort described are challenged, it will be the IRS asserting that, on the basis of substance over form, the transferred asset's basis should remain the same as it was in the hands of the transferor. Whether the judiciary will embrace the IRS entreaties to accept the doctrine's application remains to be seen.

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The three foregoing transfer tax–saving devices are simply representative. Estate planners have a large repertoire of additional techniques at their disposal to minimize taxpayers' transfer tax burdens.[103] And try as the IRS might to employ the substance over form doctrine to defeat taxpayer shenanigans, courts have mostly blocked the agency's efforts to do so.[104]

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100. *See generally* Joseph M. Dodge, *Beyond Estate and Gift Tax Reform: Including Gifts and Bequests in Income*, 91 HARV. L. REV. 1177 (1978) (explaining the role of gifts in the context of the income and transfer tax systems).

101. I.R.C. § 6019 (2018).

102. *Id.* § 2010(c).

103. *See generally* Edward M. Manigault & Milford B. Hatcher Jr., *GRATS and GST Planning—Potential Pitfall and Possible Planning Opportunity*, 20 PROB. & PROP. 28 (2006) (describing the estate planning benefits associated with the use of grantor-retained annuity trusts).

104. *See, e.g.*, Knight v. Comm'r, 115 T.C. 506, 514–15 (2000) (refusing the IRS's invitation to apply the substance over form doctrine to unwind taxpayer's transaction).

IV. THE JUDICIARY AND ITS RELUCTANCE TO EMPLOY THE SUBSTANCE OVER FORM DOCTRINE

To be clear, it would be inaccurate to claim that judges never employ the substance over form doctrine in the transfer tax realm. Judges do use the substance over form doctrine, although such use is exceedingly rare. In Section A, this analysis examines those situations when the judiciary occasionally relies upon the substance over form doctrine even in this realm; in Section B, this analysis offers possible reasons why this phenomenon is such a rarity.

A. The Substance over Form Doctrine: Limited Utilization in the Transfer Tax Realm

When it comes to transfer tax adjudication, in a few limited situations involving instances of obvious abuse, the IRS has successfully invoked the substance over form doctrine. Consider three examples of its application.

One example involves reciprocal transfers. In a wonderfully named case, *United States v. Estate of Grace*,[105] the Supreme Court acknowledged that the substance over form doctrine has a role to play in the transfer tax arena.[106] In this case, the taxpayer and his wife sought to ensure mutual financial protection while simultaneously seeking to minimize their estate tax exposure. To accomplish these dual objectives, the husband and wife prepared reciprocal trusts for each other's benefit whereby neither would be bereft of assets (i.e., the husband contributed assets into trust for his wife's benefit, and, conversely, his wife contributed assets into trust for her husband's benefit).[107] Had each spouse independently established a trust for his/her own benefit and retained an interest therein, the creation of such trusts would have resulted in estate tax being imposed upon each grantor's gross estate.[108] By going through the reciprocal trust exercise, however, the married couple sought to circumvent this explicit congressional directive. Had they been successful, they would have blazed a gaping hole in the estate tax base. On this exceptional occasion, though, the judiciary decided to buck its traditional willingness in the transfer tax realm to respect the form of a transaction even when its

105. 395 U.S. 316 (1969).
106. *Id.* at 323 (citing Est. of Spiegel v. Comm'r, 335 U.S. 701, 705–06 (1949)).
107. *Id.* at 318–19.
108. I.R.C. § 2036(a) (2018).

substance is quite different. Instead, it deemed this arrangement to be wholly ineffective in removing assets from the respective spouses' transfer tax bases.[109] In cases involving virtually identical fact patterns, several other courts have followed the Supreme Court's lead in *Estate of Grace*.[110]

Another transfer tax situation in which courts have demonstrated a willingness to invoke the substance over form doctrine is when taxpayers seek to orchestrate their affairs to avoid possible gift tax inclusion in their gross estates. In *Estate of Sachs v. Commissioner*,[111] for example, less than three years before his death in 1980, Samuel Sachs and his wife gifted stock worth approximately $2.3 million to irrevocable trusts established for the benefit of their grandchildren.[112] The donation was designed as a net gift, i.e., the trust instrument required that as a condition of the gift the donee trustees satisfy all gift tax liability arising from the Sachses' stock contribution, and, in 1978, they fulfilled this obligation.[113] When Mr. Sachs died in 1980, the IRS sought to include the amount of the gift tax paid in his gross estate under Code section 2035(c), which then stated that "[t]he amount of the gross estate . . . shall be increased by the amount of any tax paid . . . by the decedent or his estate on any gift made by the decedent or his spouse . . . during the 3-year period ending on the date of the

109. *See Est. of Grace*, 395 U.S. at 320. "The doctrine of reciprocal trusts was formulated in response to attempts to draft instruments which seemingly avoid the literal terms of § [2036(a)], while still leaving the decedent the lifetime enjoyment of his property." *Id.*

110. An interesting variant of the reciprocal gift situation is one in which multiple gifts are made to members of a junior generation by members of a senior generation in an effort to make the maximum use of the annual exclusion. A case that presented this situation in a rather perfect form was *Sather v. Commissioner*, 251 F.3d 1168 (8th Cir. 2001). In *Sather* there were three brothers, each of whom conveniently had three children. *Id.* at 1170. The brothers decided that each would give an annual gift in an amount equal to approximately the maximum annual exclusion at the time ($10,000) to each of his own children, and similar gifts to each niece and nephew. *Id.* Their spouses did the same. *Id.* The result was that each child received gifts totaling $60,000, instead of the $20,000 that they would have been limited to had they gotten gifts from only their own parents. *Id.* The U.S. Court of Appeals for the Eighth Circuit, however, ruled that only $20,000 qualified for the annual exclusion because the substance of the transaction was to make large gifts to each taxpayer's own child rather than smaller gifts to each son, daughter, niece, and nephew. *Id.* at 1175; *see also* Schultz v. United States, 493 F.2d 1225, 1225–26 (4th Cir. 1974) (ruling that gifts made by two brothers were reciprocal where they each gifted stock in a closely held corporation to their own three children and their sibling's three children); Exch. Bank & Tr. Co. of Fla. v. United States, 694 F.2d 1261, 1269 (Fed. Cir. 1982) (applying reciprocal trust doctrine where each parent relinquished control over the same number of shares that each gained as a custodian for the benefit of their minor children).

111. 856 F.2d 1158 (8th Cir. 1988).

112. *Id.* at 1159.

113. *Id.*

decedent's death."[114] The estate countered by declaring that the donee trustees had paid the gift tax, thereby negating its inclusion in the decedent's gross estate.[115] In rendering its decision in the IRS's favor, the U.S. Court of Appeals for the Eighth Circuit ruled that "[w]here taxpayers have structured indirect transactions to obtain tax advantages, the law typically looks to the substance, and not the form of the transaction."[116] Here, the payment of the gift tax, though paid by the donee trustees, was tantamount to being paid by the donor and thus includable in his gross estate. Other cases involving similar fact patterns involving net gifts have yielded the same outcomes.[117]

A final situation in which courts have demonstrated a willingness to ignore the form of a transaction and focus instead on its substance is when transfers have amounted to fraud. An emblematic case is *Estate of Cidulka v. Commissioner*.[118] In *Cidulka*, to exploit the gift tax annual exclusion, a donor transferred stock to his son, daughter-in-law, and grandchildren.[119] However, when the daughter-in-law received the gifted shares, she immediately transferred them to her husband (i.e., the transferor's son);[120] furthermore, the grandchildren never secured any of the benefits associated with corporate stock ownership insofar as when the corporate assets were sold, they failed to receive their pro rata share of the proceeds.[121] In this case and similar ones, the courts have held that the substance over form doctrine applies and have ruled in the IRS's favor.[122]

The foregoing situations each involved transparent attempted work-arounds of well-established Code provisions. In each of these situations, the IRS was willing to employ the substance over form doctrine to combat these ploys, with the ultimate endorsement of the courts. The courts' willingness to venture beyond pure textualism is likely reflective of their perceived role as protectors of the Code,

114. I.R.C. § 2035(c) (1988) (current version at I.R.C. § 2035(b) (2018)).

115. *Estate of Sachs*, 856 F.2d at 1163.

116. *Id.* at 1164.

117. *See, e.g.*, Est. of Morgens v. Comm'r, 678 F.3d 769, 776 (9th Cir. 2012) (finding that gift taxes paid by gift recipients were includable in the decedent's gross estate); Brown v. United States, 329 F.3d 664, 675 (9th Cir. 2003) (holding that even though in form the wife paid the gift tax liability on the husband's gift, in substance it was the husband's funds that paid the gift tax).

118. 71 T.C.M. (CCH) 2555 (1996).

119. *Id.* at 2556–57.

120. *Id.* at 2556.

121. *Id.* at 2557.

122. *Id.* at 2565–66; *see, e.g.*, Heyen v. United States, 945 F.2d 359, 365 (10th Cir. 1991) (holding that use of intermediaries to capitalize upon the annual exclusion was ineffectual); Est. of Bies v. Comm'r, 80 T.C.M. (CCH) 628, 631–32 (2000) (same).

safeguarding it from those taxpayers who seek to trample upon its fundamental tenets. Furthermore, beyond institutional preservation of the transfer tax base, judges also try to protect their personal reputations and, even in the transfer tax realm, do not wish the public to perceive them as unwitting abettors to taxpayers' tax abuse.[123]

B. The Substance over Form Doctrine: The Puzzle of Judicial Acquiescence

In more complex transfer tax planning situations, however, such as the three types of transactions described in Part III as well as other transactions,[124] the courts have greeted IRS challenges that rely upon the substance over form doctrine with far more skepticism. The question is why. This section offers our speculations about the reasons for the judiciary's hands-off approach with regard to transfer tax situations and the substance over form doctrine and then outlines the concomitant consequences.

One imaginable reason that judges are more deferential to taxpayers in the transfer tax context may be that the deeds under analysis are acts of *giving*—which might at first blush seem like manifestations of altruism. More specifically, when taxpayers make gratuitous transfers and seek to minimize their transfer tax exposure, their actions may superficially appear to be laudable measures to financially protect their loved ones. Yet, upon deeper reflection, this sort of reverent attitude appears unwarranted. After all, taxpayers cannot take their worldly possessions with them into whatever comes next, so it follows that those assets must ultimately pass to *someone*. Thus, in the life/death context, giving to a family member, a close relative, or a friend does not reflect altruism or selflessness; it is virtually the opposite. Therefore, taxpayers deserve no special concessions on grounds of their supposed unselfishness.

Another possible explanation for the judiciary's hesitancy to embrace the substance over form doctrine is the fact that transfer taxes are particularly disliked—at least by those who will be, or think that they might be, subject to them.[125] As a group, targets of the estate

123. *See, e.g.*, Ashley Deeks, *Secrecy Surrogates*, 106 VA. L. REV. 1395, 1416 (2020) ("[J]udges seek to preserve their reputation among their peers and the public.").

124. See cases cited *supra* Part III; *see, e.g.*, Dodge, *supra* note 74 (explaining other transfer tax strategies and the need for legislative reform).

125. This animus is nicely detailed in chapter 6 of a book authored by David Cay Johnston. DAVID CAY JOHNSTON, PERFECTLY LEGAL: THE COVERT CAMPAIGN TO RIG OUR TAX SYSTEM TO BENEFIT THE SUPER RICH—AND CHEAT EVERYONE ELSE 71–91 (2003); *see also* Richard L.

tax—society's most financially prosperous citizens[126]—often believe that their wealth has already endured a gauntlet of tax burdens and should not be subject to yet another one.[127] And there is an abundance of evidence that judges are largely selected from among those who are economically well-to-do.[128] It is easy to imagine that their socioeconomic status may incline them to harbor a negative view toward wealth transfer taxes.

A final factor that could play a part in the gentle judicial oversight of the nation's transfer tax system is that these taxes have long been viewed as having the airy quality of Swiss cheese. Testifying before the Ways and Means Committee, Harvard Law School Professor A. James Casner once declared, "[W]e haven't got an estate tax[;] what we have, you pay an estate tax if you want to; if you don't want to, you don't have to."[129] A few years later, George Cooper, a Columbia law professor, elaborated upon Casner's characterization, affirming its central tenets.[130] Because the wealth transfer taxes have comprehensive deductions for gifts and bequests made to charities or a surviving spouse,[131] there is technical truth in the claims of Professors Casner and Cooper. However, if a testator's desire is (as is usually the case)

Schmalbeck, *Class War and the Estate Tax: Have the Troops Gone AWOL?*, *in* LAW AND CLASS IN AMERICA: TRENDS SINCE THE COLD WAR 191 (Paul D. Carrington & Trina Jones eds., 2006) (exploring the reasons why the American public appears to support repeal of the estate tax).

126. The estate tax currently (in 2022) exempts $12,060,000 from tax. I.R.C. § 2010(c) (2018). This large dollar figure protects the vast majority of taxpayers from transfer tax exposure. Indeed, by way of example, in 2018 (when the estate tax exemption was $11,180,000), only a mere 2,000 or so of the nation's wealthiest estates were subject to the estate tax. *See How Many People Pay the Estate Tax?*, TAX POL'Y CTR. (2021), https://www.taxpolicycenter.org/briefing-book/how-many-people-pay-estate-tax [https://perma.cc/2VQX-GER8] (estimating 1,900 taxable estates in 2018).

127. *See, e.g.*, Edmund L. Andrews, *Death Tax? Double Tax? For Most, It's No Tax*, N.Y. TIMES (Aug. 14, 2005), https://www.nytimes.com/2005/08/14/business/yourmoney/death-tax-double-tax-for-most-its-no-tax.html [https://perma.cc/W56Q-PSCP] ("And while opponents contend that the estate tax is a 'double tax,' . . . .").

128. *See, e.g.*, Michele Benedetto Neitz, *Socioeconomic Bias in the Judiciary*, 61 CLEV. ST. L. REV. 137 (2013) (explaining how, due to their wealth and socioeconomic position, judges harbor implicit biases).

129. *Federal Estate and Gift Taxes: Hearing Before the H. Ways & Means Comm.*, 94th Cong. 1335 (1976). Others have made similar claims. *See, e.g.*, Jeffrey S. Kinsler, *A Comparative Proposal to Reform the United States Gift Tax Annual Exclusion*, 30 VAND. J. TRANSNAT'L L. 949, 952 (1997) ("United States citizens are not required to pay estate and gift taxes! In fact, the only people who should pay such taxes are those wishing to donate money to the U.S. government."); Edward J. McCaffery, *Tax Policy Under a Hybrid Income Consumption Tax*, 70 TEX. L. REV. 1145, 1215 (1992) (remarking that "the system is so racked with exceptions, exemptions, and exclusions that hardly anyone actually pays any wealth transfer tax").

130. George Cooper, *A Voluntary Tax? New Perspectives on Sophisticated Estate Tax Avoidance*, 77 COLUM. L. REV. 161, 164 (1977).

131. I.R.C. §§ 2055(a), 2056(a) (2018).

to pass substantial wealth to succeeding family generations, then the Casner/Cooper characterizations border on hyperbole.[132] Yet, regardless of their truth, the widespread notion that these taxes are easily avoided has contributed to a sense that Congress has been complicit in creating—and failing to reform—a wealth transfer tax system that is more or less intentionally leaky. In other words, many commentators claim that Congress must have *meant* for the courts to interpret the Code in a manner that is generous to donors and their estates. That being the case, why would a court wish to thwart the legislature's apparent intent?

The main consequence associated with the judiciary's reluctance to employ the substance over form doctrine boils down to a severe loss of transfer tax revenue. Although the IRS projects that the tax gap—the difference between what taxpayers actually pay in taxes in a timely manner and what they should pay if they fully comply with the tax laws[133]—associated with the estate tax is currently $1 billion annually,[134] this dollar figure only captures truly abusive arrangements and/or the failure to report otherwise taxable transfers. However, it does not capture so-called plain-vanilla arrangements (such as the three highlighted in Part III of this analysis) that the courts have sanctioned. Due to the popularity of these transfer tax strategies, it is easy to imagine with billions of dollars of wealth being transferred annually that a lot of potential tax revenue is inappropriately avoiding collection inappropriately.[135]

In addition to the obvious revenue loss, the judiciary's laissez-faire approach toward statutory interpretation tends toward the very

132. *See* Paul L. Caron & James R. Repetti, *The Estate Tax Non-Gap: Why Repeal a "Voluntary" Tax?*, 20 STAN. L. & POL'Y REV. 153, 154 (2009) (pointing out that the nation's transfer tax system is not easily avoided, which is why the wealthy have heavily lobbied to have Congress repeal it); *see also* Richard Schmalbeck, *Avoiding Federal Wealth Transfer Taxes*, *in* RETHINKING ESTATE AND GIFT TAXATION 113, 145–46 (William G. Gale, James R. Hines Jr. & Joel Slemrod eds., 2001).

133. Robert E. Brown & Mark J. Mazur, *IRS's Comprehensive Approach to Compliance Measurement*, 56 NAT'L TAX J. 689, 689 (2003) (defining the tax gap); Mark J. Mazur & Alan H. Plumley, *Understanding the Tax Gap*, 60 NAT'L TAX J. 569, 569 (2007) (same).

134. INTERNAL REVENUE SERV., FEDERAL TAX COMPLIANCE RESEARCH: TAX GAP ESTIMATES FOR TAX YEARS 2011–2013 (2019), at 3, https://www.irs.gov/pub/irs-pdf/p1415.pdf [https://perma.cc/372J-9G7M].

135. *See, e.g.*, Matthew Heimer, *How Billionaires Beat the Estate Tax*, MARKETWATCH (Dec. 20, 2013, 1:36 PM), https://www.marketwatch.com/story/how-billionaires-beat-the-estate-tax-1387564611 [https://perma.cc/4RA8-X2EV] (relying upon another transfer tax-avoidance strategy known as grantor-retained annuity trusts (GRAT), "Sheldon and Miriam Adelson have used GRATs to pass $7.9 billion worth of wealth to their children since 2010—most of it in the form of stock in Las Vegas Sands Corp., which Sheldon Adelson founded in 1988.").

result that Professors Casner and Cooper imagined—a wealth transfer tax system that is a mockery. Taxpayers who participate in various tax machinations—such as Crummey trusts, family limited partnerships, and upstream planning—likely smirk as they are able to save thousands, millions, or, in some cases, billions in transfer tax dollars.[136]

But it doesn't have to be this way.

V. TWO POSSIBLE PATHS TO REFORM

There is no magic wand that one can wave to make the judiciary more willing to use the substance over form doctrine in rendering its transfer tax adjudications. However, there are certain steps that Congress could take to make the use of this doctrine more likely. Furthermore, the judiciary could, on its own initiative, cast aside its pattern of excessive reliance on the form of transactions rather than on their substance. Below, Section A details a possible legislative approach, and Section B investigates a judicial approach to achieving much-needed reform.

A. Legislative Approach

In crafting remedial measures, Congress has sometimes cast a wide net;[137] other times, its methodology has been narrower.[138] In addressing the problem of transfer tax abuse, Congress should follow the same dual strategy: on the one hand, adopt a comprehensive approach

136. *See* Jeff Camarda, *Estate Plan Secrets & How to Avoid Estate Tax (Part 1 of 2)*, FORBES (Feb. 4, 2020, 12:01 PM), https://www.forbes.com/sites/jeffcamarda/2020/02/04/estate-plan-secrets--how-to-avoid-estate-tax-part-1-of-2/ [https://perma.cc/R6HT-PH8W] (detailing ways to minimize the estate tax burden that a family endures); Jeff Camarda, *Estate Plan Secrets & How to Avoid Estate Tax (Part 2 of 2)*, FORBES (Feb. 4, 2020, 12:40 PM), https://www.forbes.com/sites/jeffcamarda/2020/02/04/estate-plan-secrets--how-to-avoid-estate-tax--part-2-of-2/ [https://perma.cc/TZ6K-33TL] (same).

137. *See, e.g.*, Foreign Account Tax Compliance Act of 2010, Pub. L. No. 111-147, §§ 501–562, 124 Stat. 97, 97 (introduced as part of the Hiring Incentives to Restore Employment Act). This legislation introduced a broad range of rules to ensure that U.S. taxpayers making foreign investments were tax compliant. Melissa A. Dizdarevic noted in her Comment that

> [i]n an effort to crack down on offshore tax evasion, the United States is implementing a new set of information reporting and withholding requirements on foreign banks and other foreign entities. These provisions, known as the Foreign Account Tax Compliance Act (FATCA) . . . require thirty percent withholding of the entity's U.S.-source income, unless they disclose specific information regarding their customers' identities and account balances.

Melissa A. Dizdarevic, Comment, *The FATCA Provisions of the Hire Act: Boldly Going Where No Withholding Has Gone Before*, 79 FORDHAM L. REV. 2967, 2967 (2011).

138. *See, e.g.*, I.R.C. § 469(a) (2018) (limiting the availability of passive losses to offset active income).

that has an overall chilling effect on planning of this sort; and, on the other hand, embrace a targeted approach that eradicates known abuses.

A comprehensive approach to the problem of tax abuse is not uncharted territory. For example, in 2010, after learning about a litany of tax-sheltering devices that taxpayers had employed to skirt their tax obligations—devices with obscure acronymic names such as BOSS, Son of BOSS, and COBRA[139]—Congress introduced Code section 7701(o), entitled "Clarification of the Economic Substance Doctrine."[140] This Code subsection provides a ringing endorsement of the economic substance doctrine (a subset of the substance over form doctrine). In taking this legislative measure, Congress was able to accomplish two goals. First, it greatly strengthened the IRS's ability to challenge those transactions lacking economic substance; and, second, it provided safe refuge to those courts previously hesitant to rely upon judicial doctrines in rendering their decisions.[141]

In other instances, Congress has not enacted such broad and sweeping legislation but, instead, has chosen to attack specific instances of perceived income tax abuse. In *Gitlitz v. Commissioner*,[142] for example, the Supreme Court upheld the taxpayer's position that notwithstanding the fact that cancellation of indebtedness income is excludable under section 108, it nevertheless constituted an "item of income" that increases an S corporation shareholder's stock basis under section 1366(a)(1)(A).[143] Sensing the possibility of near-term horizon abuse (namely, no income recognition yet a tax basis

139. For a nice overview of how tax professionals designed these tax-circumvention strategies, see Del Wright Jr., *Financial Alchemy: How Tax Shelter Promoters Use Financial Products to Bedevil the IRS (and How the IRS Helps Them)*, 45 ARIZ. ST. L.J. 611 (2013).

140. Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, § 1409(a), 124 Stat. 1029, 1067.

141. *See, e.g.*, Rebecca Rosenberg, *Codification of the Economic Substance Doctrine: Substantive Impact and Unintended Consequences*, 15 HASTINGS BUS. L.J. 55, 55–58 (2019) (offering a general explanation of how Code section 7701(o) operates and the broad implications it has had in promoting tax compliance); Bret Wells, *Economic Substance Doctrine: How Codification Changes Decided Cases*, 10 FLA. TAX REV. 411, 428–51 (2010) (predicting the effects that this legislation would have on future tax litigation).

142. 531 U.S. 206 (2001).

143. *Id.* at 213–14.

increase),[144] Congress quickly amended Code section 108(d)(7)(A) to preclude this outcome.[145]

When it comes to income tax abuses, Congress has thus demonstrated a low tolerance level for activities of this sort. This same congressional attitude should extend to transfer tax abuses: employing the identical playbook, it should craft both broad and targeted legislation designed to curtail anticipated and existing transfer tax abuses. Consider the proposed mechanics of each approach.

Insofar as a broad approach is concerned, Congress, using Code section 7701(o) as a model, could fashion legislation that would be applicable to gratuitous transfers. Engrafted onto 7701 and introduced as subsection (p), such legislation might read as follows:

> (p) Clarification of the Application of the Substance over Form Doctrine to Transfer Tax Transactions
>
> Absent a specific Congressional provision to the contrary, in cases involving any transaction that has as one of its primary purposes the defeat of taxes assessed under Chapter 11, 12, or 13 of the Code (relating to the estate, gift, and generation-skipping transfer tax) or that has as one of its purposes the diminution of capital gains taxes assessed under Chapter 1 of the Code (relating to income taxes), courts should employ the substance over form doctrine and accord an outcome consistent with the taxpayer's actual objectives.

In the sphere of estate planning, such a sweeping legislative initiative would have a significant impact. By applying the substance over form doctrine, the IRS, notwithstanding the existence of Crummey powers (i.e., limited withdrawal rights), could deem taxpayers who made trust contributions as having made future-interest gifts. And because no taxpayer purposely seeks to destroy the value of her property, the agency could disallow valuation discounts related to intrafamily

144. *See* James F. Loebl, *Does the Excluded COD Income of an Insolvent S Corporation Increase the Basis of Shareholders' Stock?*, 52 FLA. L. REV. 957, 957–58 (2000) (under these circumstances, explaining the controversial nature of according a tax basis increase to a shareholder's stock interest); Gregg D. Polsky, *Another* Gitlitz *Windfall: Double Basis Increases for S Corp. Shareholders?*, 92 TAX NOTES 314 (2001) (same).

145. Job Creation and Worker Assistance Act of 2002, Pub. L. No. 107-147, 116 Stat. 21, 40 (2002). This is not an isolated instance of Congress trying to plug the metaphoric revenue dike against tax abuse leaks; to the contrary, the nation's legislative body routinely engages in exercises of this sort. *See, e.g.*, Scott Marc Kolbrenner, *Derivatives Design and Taxation*, 15 VA. TAX REV. 211, 253 (1995) ("By enacting section 1092 of the Code, Congress sought to prevent taxpayer abuse of straddles, trading methods whereby a taxpayer owns offsetting positions but only realizes the loss (not the gain) until it is to his advantage to realize the gain.").

property transfers. Finally, it could ignore upstream transfers and treat such transfers as if they were made directly to the transferor's intended beneficiary (or not made at all, in the case of purported gifts that revert to the original transferor) rather than to the intermediary straw person being used to achieve a tax basis step-up. Going forward, estate planners who devised elaborate schemes designed to circumvent income or transfer tax obligations would have to consider whether such strategies could withstand the heightened scrutiny that proposed Code section 7701(p) would provide.

But many members of Congress might be hesitant to empower the IRS with a statutory weapon of this sort. If this turns out to be the case, Congress could instead fashion legislation designed to nullify each particular tax-minimization strategy. On many different occasions, academics have specifically suggested targeted legislative measures that would put an end to Crummey trusts,[146] valuation discounts related to intrafamily transfers of business interests,[147] upstream planning,[148] and a host of other planning devices.[149] To date, however, such proposals have languished, provoking no congressional response.

While Congress should seriously consider instituting the proposed targeted measures, it might be more productive if it also adopted the broader, more general legislative approach. This is because a case-by-case approach forces the IRS to play catchup rather than positioning the agency to challenge newly minted transfer tax–avoidance schemes as they arise.

B. Judicial Approach

Even a cursory review of Part II of this analysis reveals that, when necessary, courts are adept at using the substance over form doctrine to reach their decisions. The question is how to nudge judges to extend this mode of thinking into the transfer tax realm. This seems mostly a

146. *See, e.g.*, Arash, *supra* note 59, at 126 ("Given such blatant abuse of the annual exclusion for purposes of gift and estate tax avoidance, a revision in the tax law is necessary to deter taxpayers from engaging in such tax avoidance schemes.").

147. *See, e.g.*, Fellows & Painter, *supra* note 69, at 932 (offering "statutory amendments to the Internal Revenue Code to prevent unwarranted tax avoidance of the wealth transfer taxes [via valuation discounts]").

148. *See, e.g.*, Jay A. Soled, *Upstream Tax Planning: A Case Study of Why Congress Should Institute a General Anti-Abuse Rule*, 99 N.C. L. REV. 643, 643 (2021) (attacking upstream tax planning as favoring form over substance).

149. *See* Dodge, *supra* note 74, at 1014–15 (recommending the statutory elimination of dynasty trusts, which are specifically designed to circumvent the legislative intent of levying a transfer tax once at every generational level).

matter of exhortation: on their own initiative, judges can and should carve a new path—that other courts might find logically inviting and structurally sound—moored to the substance over form doctrine. After all, a flair for creativity has been a trademark of the federal judiciary. Examples include the assignment of income doctrine,[150] the independent investor test,[151] the significant future benefit metric,[152] and other judicial measures[153] that have sprung from the creative minds of innovative jurists.

It is worth noting that the root of all of our examples of transfer tax abuses involves a purported transfer to one party that is truly intended for another. In the case of Crummey trusts, the Crummey withdrawal power holders are not the intended beneficiaries of the trust contribution, at least not immediately; rather, the trust itself is the beneficiary.[154] In the case of fractional property interest transfers, the intention is that the named recipients subrogate their personal agendas for those of the family unit, which, as a whole, is the true recipient.[155] And in the case of upstream tax planning, depending upon how this arrangement is structured, the intended beneficiary is not the older family individual or trust beneficiary who is the purported donee, but rather the donor himself, a younger family member, or the trust remainder beneficiaries.[156]

In recognition of the fact that transfer tax abuse often involves camouflaging the true beneficiary of a gratuitous transfer, one or more members of the judiciary should unpeel these synthetic layers of gratuitous and testamentary transfers. On the basis of the substance over form doctrine (or, materially the same approach, but by some other moniker such as the "proper beneficiary identification doctrine"), a thoughtful judge should examine the true essence of every transfer and insist that it be taxed accordingly. In *Estate of Grace*,[157] for example, the U.S. Supreme Court laid the seeds for this principle by formulating the reciprocal trust doctrine—recognizing that the true trust

150. *See* Lucas v. Earl, 281 U.S. 111, 114–15 (1930).
151. Exacto Spring Corp. v. Comm'r, 196 F.3d 833, 838–39 (7th Cir. 1999).
152. INDOPCO, Inc. v. Comm'r, 503 U.S. 79, 87 (1992).
153. *See, e.g.*, Daniel M. Schneider, *Use of Judicial Doctrines in Federal Tax Cases Decided by Trial Courts, 1993–2006: A Quantitative Assessment*, 57 CLEV. ST. L. REV. 35, 58–69 (2009) (presenting empirical data regarding the robust use of various judicial doctrines in tax jurisprudence).
154. *See supra* Section III.A.
155. *See supra* Section III.B.
156. *See supra* Section III.C.
157. 395 U.S. 316 (1969).

beneficiary of each trust was not the one actually designated in the trust instrument but rather the trust grantor himself/herself.[158]

Were the judiciary to invoke the substance over form doctrine or some formulation of the same, many of the principal transfer tax abuse schemes would fail. Transfers to irrevocable trusts would no longer qualify as present interests; valuation discounts related to intrafamily transfers would disappear; and, in the case of upstream tax planning, the initial trust beneficiary's supposed indicia of ownership would be ignored as mere subterfuge, and the contributed trust assets would thus retain their carryover tax basis.

Application of the substance over form doctrine or a newly crafted/named judicial doctrine that is similar in nature would not eliminate all transfer tax abuses, but its application would be a significant step in the right direction. In the transfer tax realm, this would bring much-needed consistency to the judicial enterprise of meting out justice fairly and equitably.

VI. CONCLUSION

For over a century, the nation has relied upon its transfer tax regime as a source of revenue and mitigation of wealth concentrations.[159] However, its ability to fulfill its historic missions has been hampered by the fact that the judiciary has been reluctant to apply the substance over form doctrine to challenge a wide range of transfer tax-mitigation schemes. The consequences of the judiciary's inaction have been severe: utilization of these techniques significantly narrows the transfer tax base, enabling billions of dollars of wealth to pass free of transfer tax and allowing wealth concentrations to abound.[160]

158. *See* Elena Marty-Nelson, *Taxing Reciprocal Trusts: Charting a Doctrine's Fall from* Grace, 75 N.C. L. REV. 1781, 1781 (1997) (extolling the virtues of the reciprocal trust doctrine, explaining that "[w]hen settlors began creating 'crossed trusts' to evade estate tax liability, the Internal Revenue Service obtained Supreme Court precedent in *United States v. Estate of Grace* allowing it to tax the 'economic reality' of such trusts").

159. *See* James R. Repetti, *Democracy, Taxes, and Wealth*, 76 N.Y.U. L. REV. 825, 852 (2001) (explaining the need to retain the estate tax to reduce wealth concentrations); Carlyn S. McCaffrey & John C. McCaffrey, *Our Wealth Transfer Tax System—A View from the 100th Year*, 41 ACTEC L.J. 1, 9 (2015) ("The 1916 Congressional debates show that 59% of the supporters of the tax did so because of the need for revenue combined with a belief that using an estate tax to raise needed revenue was a fair way to do it.").

160. *See, e.g.*, David Joulfaian, *What Do We Know About the Behavioral Effects of the Estate Tax?*, 57 B.C. L. REV. 843, 858 (2016) ("The estate tax base has been eroded considerably by the expanded exemption and other preferences introduced over the past several decades. . . . Despite its narrow tax base, the estate tax continues to contribute to the progressivity of the tax system, albeit with a diminished capacity.").

To restore the integrity of the transfer tax system, this analysis calls for a legislative and/or judicial approach to resolving the issue of transfer tax schemes that lack substance. One option is for Congress, via legislation, to endorse the use of the substance over form doctrine in the transfer tax context. The other option is for the judiciary to utilize the substance over form doctrine to undo transactions that are wholly synthetic in nature.

By enabling the substance over form doctrine to become an integral part of the transfer tax regime, Congress and the judiciary would simultaneously enhance revenue collection and decrease wealth inequality. And with the nation's deficit raging at an all-time-high[161] and wealth inequality rampant,[162] these are outcomes that each should actively pursue.

161. Martin Crutsinger, *U.S. Budget Deficit Hits All-Time High of $3.1 Trillion*, PBS (Oct. 16, 2020, 2:23 PM), https://www.pbs.org/newshour/economy/u-s-budget-deficit-hits-all-time-high-of-3-1-trillion [https://perma.cc/FL99-KZES].

162. Tommy Beer, *Top 1% of U.S. Households Hold 15 Times More Wealth than Bottom 50% Combined*, FORBES (Oct. 8, 2020, 5:15 PM), https://www.forbes.com/sites/tommybeer/2020/10/08/top-1-of-us-households-hold-15-times-more-wealth-than-bottom-50-combined/ [https://perma.cc/TGB3-P759].