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A Comparative Proposal to Reform the United States Gift Tax Annual Exclusion

*Jeffrey S. Kinsler**

ABSTRACT

The U.S. tax system receives much criticism. Recurrent themes in criticizing tax laws concern their complexity and the many loopholes relieving the wealthy from large amounts of taxation. This Article demonstrates how very wealthy U.S. taxpayers often do not pay gift and estate taxes. In fact, the tax laws do not require these taxes to be paid. The Internal Revenue Code provides mechanisms through which taxpayers can evade estate and gift taxes in the United States. Furthermore, U.S. gift tax laws are extremely generous to taxpayers relative to tax laws of other industrialized countries.

This Article analyzes the U.S. gift tax annual exclusion, the main exemption to U.S. gift tax laws. The Article develops the history and purpose of the gift tax annual exclusion to demonstrate that the current system does not accomplish its original purposes. The Article concludes that reform is needed and proposes legislation to simplify the gift tax laws

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* Associate Professor of Law, Marquette University Law School. I would like to thank the University of Queensland, the Australian Institute of Foreign and Comparative Law, the International Trade and Business Law Annual, Professor Gabriel Moens, and Cavendish Publishing for their invaluable assistance with this article.

and create a more equitable gift tax law system. The Article uses the gift tax laws of New Zealand, the United Kingdom, Japan, and the Netherlands as models for U.S. gift tax reform legislation.

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> *[T]here is nothing sinister in so arranging one's affairs as to keep taxes as low as possible. Everybody does so, rich or poor; and all do right, for nobody owes any public duty to pay more than the law demands . . .* [1]
>
> Judge Learned Hand (1947)

I. INTRODUCTION

Uniform transfer tax laws are essential to regional and global commerce. Without consistent tax laws, it is difficult, if not impossible, for international entrepreneurs and executives to arrange their financial affairs. As a practical matter, the lack of transfer tax consistency has led to the development of a new class of refugees: wealthy executives willing to relinquish their citizenship in exchange for advantageous tax laws.[2] This Article examines the

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1. Commissioner v. Newman, 159 F.2d 848, 850-51 (2d Cir. 1947) (Hand, J., dissenting). *See also* Helvering v. Gregory, 69 F.2d 809, 810 (2d Cir. 1934) ("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."), *aff'd*, 293 U.S. 465 (1935).

2. *See, e.g.*, Robert Lenzer & Philippe Mao, *The New Refugees*, FORBES, Nov. 21, 1994, at 131.

principal exemption to U.S. gift tax laws and proposes legislation designed to harmonize the gift tax laws of the United States with those of other industrialized nations, particularly New Zealand, the United Kingdom, Japan, and the Netherlands.

A. *The U.S. Gift Tax*

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.[3] Everyone else is spared this burden because transfer taxes are not compulsory.

By now many readers must be asking the obvious question: How many years in prison would one receive for claiming this tax-free status? The answer, quite surprisingly, is zero, as it is entirely lawful to evade estate and gift taxes in the United States. Transfer tax[4] evasion is, in fact, authorized, nay, encouraged by the Internal Revenue Code (hereinafter I.R.C.) in a provision known as the gift tax "annual exclusion."[5]

Briefly stated, the annual exclusion is the single largest loophole in the transfer tax system, and it has, in effect, converted the U.S. comprehensive estate and gift tax scheme into a system of welfare for the wealthy. If Congress is serious about reforming U.S. welfare programs, the annual exclusion should be a key part of such reform.[6]

B. *The Role of the Annual Exclusion in Estate and Gift Tax*

To appreciate the importance of the gift tax annual exclusion, one must understand the role it plays in our estate and gift tax system.[7] Tax experts have maintained for decades that a death tax is an essential component of a progressive and equitable system of

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3. *See generally* George Cooper, *A Voluntary Tax? New Perspectives On Sophisticated Estate Tax Avoidance*, 77 COLUM. L. REV. 161 (1977).

4. As used herein, the term "transfer taxes" includes estate tax, gift tax and generation-skipping tax. *See, e.g.*, HAROLD DUBROFF & DOUGLAS A. KAHN, FEDERAL TAXATION OF ESTATES, GIFTS, AND TRUSTS 3 (3d ed.1980).

5. I.R.C. § 2503(b) (1996).

6. Recent tax laws have increased the annual exclusion, not decreased it. The Taxpayer Relief Act of 1997 (H.R. 2014) provides for the annual exclusion, among other tax provisions, to be indexed for inflation starting in 1998. *Summary of Revenue Provisions of H.R. 20145*, [1997] 16 Stand. Fed. Tax Rep. (CCH) ¶ 45,932, at 75,964 (Aug. 1, 1997). Such measures raise serious doubts about the objectives of Congress.

7. *See generally* Louis S. Harrison, *The Strategic Use of Lifetime Gifting Programs to Reduce Estate Taxes in Light of Recent Congressional and Internal Revenue Service Antipathy Towards Transfer Tax Reduction Devices*, 40 DEPAUL L. REV. 365, 375 (1991) ("Annual exclusion gifts remain an effective means to reduce eventual estate taxes.").

taxation,[8] particularly in the absence of an annual tax on accumulated wealth.[9] This conviction is debatable.[10] What is not debatable, however, is that if a tax is assessed on testamentary wealth transfers, either by means of an inheritance or estate tax, a tax must also be levied on inter vivos gratuitous transfers of property.[11] Otherwise, taxpayers can easily evade the death tax simply by transferring all wealth before death.[12] The gift tax, in effect, operates as an estate tax avoidance device.

In order to operate efficiently, a gift tax must exempt from taxation certain customary gifts, such as birthday, holiday, and wedding presents.[13] No one could imagine paying tax on the "loan" of a cup of sugar to a neighbor or on a meager birthday gift to a child.[14] Not only would it be unduly burdensome to account for such gifts, but any system taxing inconsequential transfers among friends and family would be rife with fraud. Not surprisingly, in those countries in which gratuitous transfers of wealth are taxed, such as the United States, the United Kingdom, Japan, and New

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8. *See, e.g.*, Harry L. Gutman, *Reforming Federal Wealth Transfer Taxes After ERTA*, 69 VA. L. REV. 1183 (1983).

9. *See, e.g.*, Michael J. Graetz, *To Praise the Estate Tax, Not to Bury It*, 93 YALE L.J. 259 (1983). *See also* Gilbert Paul Verbit, *Taxing Wealth: Recent Proposals from the United States, France and the United Kingdom*, 60 B.U. L. REV. 1 (1980); Thomas L. Waterbury, *Taxation of Intrafamily Transfers Over Time*, 51 TEX. L. REV. 852 (1973).

10. There are at least two industrialized countries, Canada and Australia, that have abolished all forms of estate and inheritance tax. *See* Richard M. Bird, *Canada's Vanishing Death Taxes*, 16 OSGOODE HALL L.J. 133 (1978); William H. Pedrick, *Oh, To Die Down Under! Abolition of Death and Gift Duties in Australia*, 35 TAX LAW. 113 (1981). If loopholes in the estate and gift tax of the United States are not closed (this article seeks to close one such loophole), then it may be time to consider abolishing such taxes in the United States.

11. *See generally* Cooper, *supra* note 3, at 191 ("The most important technique for avoiding high taxation of extant wealth has traditionally been the making of lifetime gifts.").

12. *See generally* Stephen R. Leimberg, *Lifetime Transfers by Gift: An Overview of Federal Gift Taxation*, *in* READINGS IN ESTATE PLANNING I 8.1 (Ted Kurlowicz ed., 1987) ("If an individual could give away his or her entire estate during lifetime without the imposition of any tax, a rational person would arrange his or her affairs so that at death nothing would be subject to the federal estate tax."); GILBERT M. CANTOR & ROBERT L. FRANKLIN, THE TEN BEST WAYS TO SAVE ESTATE TAXES 133 (1978) (a lifetime gift program is one of the best ways to avoid estate tax).

13. *See generally* Joseph M. Dodge, *Redoing the Estate and Gift Taxes Along Easy-to-Value Lines*, 43 TAX L. REV. 241, 343-345 (1988) (some exclusion from gift tax is warranted to avoid turning the population at large into tax cheaters); Jean T. Adams, *Reconciling Family Law with Tax Policy: Untangling the Tax Treatment of Parental Trusts*, 46 TAX L. REV. 107, 123-27 (1990).

14. *See generally* Mark L. Ascher, *Curtailing Inherited Wealth*, 89 MICH. L. REV. 69, 143 (1990).

Zealand, no gift tax is assessed unless the gifts made by a taxpayer in a single year exceed a certain threshold amount.

C. *Annual Exclusion Abuse*

In the United States, the amount exempted from gift taxation is known as the "annual exclusion."[15] The annual exclusion was designed to obviate the necessity of keeping an account of and reporting numerous small gifts. As such, it was set at an amount sufficient to cover most wedding, holiday, and birthday gifts.[16] In 1942, the annual exclusion was set at $3000, but it was raised to $10,000 in 1981. Since that time, the annual exclusion has become the principal artifice of wealthy U.S. citizens to avoid transfer taxes.[17]

The annual exclusion enables a taxpayer to transfer $10,000 each to as many people as he or she chooses every year without incurring taxation. A married couple can double this amount. This means that a married couple with five children and fifteen grandchildren can transfer $400,000 a year to their descendants free of gift tax. Over a thirty-year period, the couple can use the annual exclusion to transfer twelve million dollars to their descendants, thereby saving millions of dollars in transfer tax.[18]

What was designed to exempt customary gifts from taxation, such as train sets and bicycles, is being used to transfer millions of dollars, tax-free, from generation to generation.[19] Even more troubling, "the exclusion has come to be thought of as an estate planning device for transfers *in addition* to birthday and Christmas presents,"[20] and consequently is being used to shield large

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15. *See* I.R.C. § 2503(b).

16. H.R. REP. NO. 72-708, at 29 (1932).

17. Boris I. Bittker, *The $10,000 Annual Per-Donee Gift Tax Exclusion*, 44 OHIO ST. L.J. 447, 448 (1983); STEPHANIE G. RAPKIN, ESTATE TAX FREEZE: TOOLS AND TECHNIQUES 5-10 (1994). *See also* Allan J. Parker, *How to Avoid Fraud Penalties in Estate Planning*, *in* 7 INST. ON EST. PLAN. 13-1 (1973) ("planning an estate to avoid taxes is entirely legitimate since the Supreme Court has often said that no one has an obligation to arrange his affairs so as to pay any more taxes than the law demands").

18. All of this can be accomplished without even filing a gift tax return. This assumes, of course, that each spouse made the gifts from his or her own resources. If, instead, the couple utilized the gift-splitting provisions of I.R.C. § 2513, the couple would have to file gift tax returns. *See generally* FREDERICK J. GERHART, THE GIFT TAX 10 (1980).

19. Stephen R. Leimberg, *Section 2503(b)--Use of Trusts and the Gift Tax Exclusion*, 38 INST. ON FED. TAX'N 42-1, 42-2 (1980).

20. Bittker, *supra* note 17, at 448 (emphasis added). For example:

> Grandmother and Grandfather have three children, two of whom are married, and four minor grandchildren. The current gross estate for estate tax purposes of Grandmother and Grandfather approximates

transfers of securities, real estate, and cash to a donor's children, as though the donor gave them nothing else during the year, not even a teddy bear or a bicycle.[21]

D. *Annual Exclusion Reform*

The purpose of this article is twofold: first, to examine the gift tax annual exclusion from a pragmatic, historical, and comparative perspective—an examination that will prove the annual exclusion is neither designed, nor used, to exempt occasional gifts from taxation, but rather has developed into a welfare entitlement for the wealthy;[22] and second, to propose new legislation that is simpler, fairer, and more in keeping with the original purpose of the annual exclusion. The gift tax laws of New Zealand, the United Kingdom, Japan, and the Netherlands are used as prototypes for the proposed legislation.[23]

II. THE FEDERAL GIFT TAX

When the federal estate tax was enacted in 1916,[24] no corresponding gift tax was established.[25] Only gifts made "in

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> $5,000,000. If Grandmother and Grandfather engage in an annual gifting program to each of the potential nine donees (three children, two spouses of those children, and four grandchildren), Grandmother and Grandfather could give away $180,000 per year without any gift tax. At the end of ten years, $1.8 million, plus the income therefrom and appreciation of that property, would have been gifted free of gift tax and would not be subject to estate tax at the grandparents' deaths. Further, if properly structured, the transfers could also avoid generation-skipping tax.

Harrison, *supra* note 7, at 376.

21. BORRIS I. BITTKER & LAWRENCE LAKKEN, 5 FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS 124-3 (1993). Although commonplace, such practice subjects the donor to potential tax evasion charges. Parker, *supra* note 17, at 13-3 (in addition to annual $10,000 gifts, "the donor also keeps right on giving birthday, wedding and Christmas gifts to the same donees, usually his children, and never reports them. Although no criminal fraud prosecutions have been discovered arising out of this type of unreported gift, in various unreported cases on audit at least there have been negligence penalties imposed.").

22. There is, of course, nothing improper in avoiding a tax by legal means. *See generally* WILLIAM J. BOWE, TAX PLANNING FOR ESTATES 23 (1949) ("[Tax avoidance] is accomplished by simply not doing the act which the state chooses to tax. Thus if a state levies a toll of $1 on a motorist for using a bridge, it is perfectly proper to avoid this charge by using the nearby ferry where the toll may be $.50.").

23. *See infra* Section VI.

24. Federal inheritance taxes were imposed for three short periods between 1797 and 1902 in order to meet temporary fiscal emergencies. JOHN R. PRICE, PRICE ON CONTEMPORARY ESTATE PLANNING 94 (1992).

25. Revenue Act of 1916, Pub. L. No. 64-271, §§ 200-212, 39 Stat. 756, 777-80.

contemplation of death" were subject to estate tax.[26] In the absence of a gift tax, the estate tax was easily evaded by taxpayers who simply transferred all property before death.[27] Besides its susceptibility to estate tax evasion, courts found it difficult to determine which gifts were made in contemplation of death:

> Scrutiny of the circumstances surrounding inter vivos transfers, however, imposed a heavy burden on tax administrators. "Life motives" and "death motives" were used by courts in determining whether transfers had been made "in contemplation of death." The results under this approach were unsatisfactory and contributed to enactment of a federal gift tax in 1924 as a necessary corollary to estate and income taxes.[28]

The United States has made only two excursions into the gift tax field.[29] The first was the 1924 gift tax, mentioned above, which was short-lived.[30] Unlike the current gift tax, the 1924 tax was calculated on an annual, non-cumulative basis.[31] It provided an annual per-donor exclusion for the first $50,000 of gifts, as well as a per-donee exclusion of $500.[32] Considering the magnitude of such exclusions, especially in 1924 dollars, many taxpayers used the exclusions to completely avoid estate taxation.[33]

The 1924 gift tax was repealed in 1926[34] as part of an overall tax reduction package.[35] In its place, Congress enacted an estate tax provision under which gratuitous transfers made within two years of death were conclusively presumed to have been made in contemplation of death and therefore subject to estate tax.[36] It was thought that this provision would frustrate most efforts to avoid estate tax.[37] The Supreme Court, however, held the conclusive

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26. *Id.*

27. *See generally* PRICE, *supra* note 24, at 94-95 ("A gift tax provides valuable protection for income and estate taxes by imposing a tax on transfers that would deplete the amount of his or her income and the size of the donor's estate.").

28. John G. Steinkamp, *Common Sense and the Gift Tax Annual Exclusion*, 72 NEB. L. REV. 106, 110 (1993) (citations omitted).

29. RICHARD B. STEPHENS & GUY B. MAXFIELD, THE FEDERAL ESTATE AND GIFT TAXES 26 (2d ed. 1967).

30. Revenue Act of 1924, Pub. L. No. 68-176, §§ 319-324, 43 Stat. 253, 313-316.

31. *Id.*

32. *Id. See also* RANDOLPH E. PAUL, 2 FEDERAL ESTATE AND GIFT TAXATION 959-61 (1942).

33. BOWE, *supra* note 22, at 30 (the 1924 gift tax was effectively avoided by spreading gifts over a period of years).

34. Revenue Act of 1926, Pub. L. No. 69-20, § 324, 44 Stat. 9, 86.

35. Steinkamp, *supra* note 28, at 110.

36. STEPHENS & MAXFIELD, *supra* note 29, at 276-77.

37. *Id.*

presumption unconstitutional in 1932,[38] inducing Congress to revisit the gift tax field.[39]

The antecedent to our modern gift tax was enacted in 1932 in an effort to increase federal revenues during the Great Depression.[40] The gift tax was thought to be a necessary companion to the estate tax, serving as a backstop to prevent estate tax avoidance.[41] The 1932 gift tax provided a $50,000 lifetime exemption and a $5000 per-donee annual exclusion.[42] Unlike its predecessor, the 1932 gift tax was cumulative in nature.[43] Hence, the more gifts a person made during life, the higher his or her marginal gift tax rate.[44]

The 1932 gift tax was designed to discourage transfers for the purpose of avoiding estate tax.[45] Nevertheless, there remained several incentives for making lifetime gifts.[46] First, the gift tax rates were approximately twenty-five percent lower than the estate tax rates.[47] Second, although the gift tax was calculated on a cumulative basis, gifts completed more than three years before death were generally not included in the donor's estate tax base.[48] Third, the gift tax had an annual exclusion for which there was no estate tax counterpart.[49] Finally, the gift tax was tax-exclusive (no tax assessed on the tax payment itself), while the estate tax was tax-inclusive (tax assessed on the property transferred as well as the tax payment itself).[50] The latter two advantages continue to exist today.[51]

In 1976, the transfer tax system was unified by adopting a single progressive rate schedule that applies to the cumulative total

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38. Heiner v. Donnan, 285 U.S. 312 (1932). The result in *Heiner* should not have been a surprise to Congress, as the Supreme Court had earlier struck down a similar state death tax provision. *See* Schlesinger v. Wisconsin, 270 U.S. 230 (1926).

39. BOWE, *supra* note 22, at 30.

40. Revenue Act of 1932, Pub. L. No. 72-154, §§ 501-531, 47 Stat. 169, 245-259.

41. *Id.*

42. Steinkamp, *supra* note 28, at 111. From 1932 to 1938, the annual exclusion was $5,000. From 1939 to 1942, it was $4,000. From 1942 to 1981, it was $3,000. Since 1981, it has been $10,000. *Id.* at 110-11.

43. *Id.*

44. *See generally* BOWE, *supra* note 22, at 30-31.

45. H.R. REP. NO. 72-708 (1932), *reprinted in* 1939-1 C.B. (Part 2) 457, 477.

46. *See generally* PRICE, *supra* note 25, at 95.

47. ROBERT S. HOLZMAN, ENCYCLOPEDIA OF ESTATE PLANNING 43 (6th rev. ed. 1989); BOWE, *supra* note 23, at 29.

48. PRICE, *supra* note 24, at 95.

49. Steinkamp, *supra* note 28, at 111.

50. *Id.*

51. *See, e.g.*, CANTOR & FRANKLIN, *supra* note 12, at 136.

of lifetime and testamentary transfers.[52] Under the unified tax system, the gift tax is assessed on the value of property transferred by the donor.[53] The tax is imposed on the donor[54] and determined by reference to all gifts made by the donor during the relevant tax period.[55] It is computed on a progressive schedule based on cumulative gifts made by the donor in his or her lifetime or, at least, since 1976.[56] Testamentary transfers are, for the most part, treated as though made in the final year of life. The marginal rate of tax is based on all taxable gifts (total gifts minus exclusions and deductions) made by a donor, both during life and at death.[57] Yet, even after the unification of the estate and gift taxes, there remain several advantages to transferring property before death, the most important of which is the annual exclusion. This has been especially true since 1981, the year Congress raised the amount of the annual exclusion to $10,000.

A. *Imposition of Gift Tax*

Before one can appreciate the intricacies of the annual exclusion, one must have a general understanding of the application of the gift tax. Consequently, this section of the Article examines the scope of the federal gift tax. First of all, the gift tax is an excise tax imposed on the transfer of property.[58] Unlike an income tax which is assessed on the receipt of money or property, an excise tax is imposed on the disbursement of property.[59] More particularly, I.R.C. Section 2501(a) assesses a tax on the "transfer of property by gift."[60] Section 2001, the corresponding estate tax statute, is supported by detailed provisions defining the term

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52. PRICE, *supra* note 27, at 96.

53. The gift tax is assessed on a calendar-year basis. I.R.C. § 2501(a)(1). Gift tax returns must be filed before April 15 of the following year. I.R.C. § 6075(b).

54. The tax is the personal liability of the donor. I.R.C. § 2502(c). The donee, however, has secondary liability for the tax, but only to the extent of the value of the gifts received. I.R.C. § 6324(b).

55. RICHARD B. STEPHENS ET AL., FEDERAL ESTATE AND GIFT TAXATION 1-17 (6th ed., 1991).

56. Leimberg, *supra* note 12, at 8.2.

57. *Id.*

58. Bromley v. McCaughn, 280 U.S. 124 (1929). *See also* DUBROFF & KAHN, *supra* note 4, at 4.

59. STEPHENS & MAXFIELD, *supra* note 29, at 279. Generally, the gift tax applies to the transfer of property by an American citizen or resident regardless of where the property is situated. JAMES F. FARR & JACKSON W. WRIGHT, JR., AN ESTATE PLANNER'S HANDBOOK 258-59 (4th ed. 1993).

60. I.R.C. § 2501(a)(1) (West 1997). *See* EDWARD F. SUTKOWSKI & KARL B. KUPPLER, ESTATE PLANNING: A BASIC GUIDE 8 (Rev. ed. 1990). ("The federal gift tax is imposed on the privilege of transferring property during lifetime of less than the fair market value of the property.").

"taxable estate."[61] By contrast, there is no comprehensive definition of the phrase "transfer of property by gift" undertaken in the gift tax sections of the I.R.C.[62]

Although the I.R.C. does not define the term "gift," it does provide that "[w]here property is transferred for less than an adequate and full consideration in money or money's worth, then the amount by which the value of the property exceeds the value of the consideration shall be deemed a gift."[63] Donative intent, a necessary element of a gift at common law, is not required for gift taxation.[64] The gift tax is imposed on the basis of the objective factors of the transfer and the circumstances under which it was made, not on the basis of the subjective motives of the donor.[65] Some courts, however, continue to look for donative intent in determining whether a taxable gift has been made.[66]

The gift tax applies to all gratuitous transfers of property, "whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible."[67] "Any transaction in which an interest in property is gratuitously passed or conferred upon another, regardless of the means or device employed, constitutes a gift subject to tax."[68] The tax applies to cash gifts, gifts of realty, and gifts of tangible and intangible personal property.[69] It also applies to transfers of life insurance, royalty rights, notes to third parties, gifts to shareholders of a corporation, and the cancellation of debt.[70] To eliminate any doubt that the gift tax had a broad scope, Congress declared:

> the terms "property," "transfer," "gift," and "indirectly" are used in the broadest and most comprehensive sense; the term "property"

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61. I.R.C. § 2001.

62. STEPHENS & MAXFIELD, *supra* note 29, at 277. Section 2503(a) provides that "[t]he term "taxable gifts" means the total amount of gifts made during the calendar year, less the deduction provided in subchapter C (section 2522 and following)." *See also* DUBROFF & KAHN, *supra* note 4, at 259 ("The definition of a gift for federal tax purposes is much broader than it is for purposes of property law.").

63. I.R.C. § 2512(b).

64. FEDERAL ESTATE AND GIFT TAXES EXPLAINED 379 (CCH 1993).

65. W. LESLIE PEAT & STEPHANIE J. WILLBANKS, FEDERAL ESTATE AND GIFT TAXATION 42-43 (1991).

66. Commissioner v. Wemyss, 324 U.S. 303, 305-06 (1945); Heyen v. United States, 945 F.2d 359, 362 (10th Cir. 1991).

67. I.R.C. § 2511(a).

68. Treas. Reg. § 25.2511-1(c)(1) (as amended in 1994).

69. *See, e.g.*, DUBROFF & KAHN, *supra* note 4, at 259 (most gifts involve the outright transfer of securities or cash).

70. *See generally* Leimburg, *supra* note 12, at 8.2; PEAT & WILLBANKS, *supra* note 65, § 4.04, at 37.

> reaching every species of right or interest protected by law and having exchangeable value.
> The words "transfer . . . by gift" and "whether . . . direct or indirect" are designed to cover and comprehend all transactions . . . whereby and to the extent . . . that property is donatively passed to or conferred upon another, regardless of the means or the device employed in its accomplishment.[71]

The courts have construed the gift tax liberally to effectuate the intent of Congress.[72] Nevertheless, the definition of a taxable gift is one of the most complex concepts in gift taxation.[73] There are, however, certain types of transfers not encompassed by the broad reach of gift taxation.

1. Incomplete Transfers

Gift tax is not imposed unless a transfer of property is complete. A gift is complete when "the donor has so parted with dominion and control so as to leave him no power to change its disposition, whether for his own benefit or for the benefit of another . . . ."[74] Accordingly, a mere promise to make a gift is not complete unless and until it becomes legally enforceable.[75] Likewise, revocable transfers, usually made in trust form, are not complete for gift tax purposes as long as the donor retains the right to revoke.[76] If, however, the donor relinquishes the power of revocation or if income is distributed to a beneficiary, such transfers are considered complete for gift tax purposes.[77] In addition, the execution of a trust instrument, without a corresponding transfer of funds, is an incomplete gift.[78]

A transfer is also incomplete if the transferor retains the power to change the recipient of a gift or to change the interests of various beneficiaries.[79] For instance, a gift in trust is not complete if the donor retains the unfettered power to change the beneficiaries of the trust. By contrast, a gift is complete if the donor retains only the right to alter the time and manner of enjoyment of the gift by the donee.[80] Likewise, a gift is not rendered incomplete simply

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71. H.R. REP. NO. 72-708, at 27 (1932), *reprinted in* 1939-1 C.B. (Part 2) 457, 478.
72. *See, e.g.*, Dickman v. Commissioner, 465 U.S. 330 (1984).
73. CHARLES L. B. LOWNDES ET AL., FEDERAL ESTATE AND GIFT TAXES 645 (1974).
74. Treas. Reg. § 25.2511-2(b) (as amended in 1983).
75. *See, e.g.*, Burnet v. Guggenheim, 288 U.S. 280, 286 (1933) ("a gift is not consummate until put beyond recall").
76. Treas. Reg. § 25.2511-2(c) (as amended in 1983).
77. *See generally* Harrison, *supra* note 7, at 388-93.
78. FEDERAL ESTATE AND GIFT TAXES EXPLAINED, *supra* note 64, at 388.
79. Treas. Reg. § 25.2511-2(c) (as amended in 1994).
80. STEPHENS ET AL., *supra* note 55, at 1-18 & 1-19.

because the transferor confers upon another the exclusive power of revocation.[81]

2. Business Transactions

Section 2512(b) provides that "[w]here property is transferred for less than an adequate and full consideration in money or money's worth, then the amount by which the value of the property exceeds the value of the consideration shall be deemed a gift."[82] If full consideration is received by the taxpayer, the taxpayer's gross estate is not diminished and thus a gift tax would be inappropriate.[83] The value of the consideration received does not necessarily have to equal the value of the consideration relinquished. A bad bargain between two unrelated parties in a bona fide business transaction is not a gift.[84] The fact that one of the parties to the transaction acquired less than he or she bargained for is harsh enough; there is no reason to compound the problem by assessing a gift tax on that person.

The presence of valid contractual consideration will not prevent a transfer from being a gift unless the consideration is full and adequate in terms of money or money's worth.[85] Consideration such as love, affection, and promises to marry, though valid at common law, are insufficient under the gift tax laws. Moreover, some transactions not considered gifts for income tax purposes may qualify as gifts for gift tax purposes, as there is no uniform definition of the term "gift" in the I.R.C.[86]

Not all business transactions are outside the scope of the gift tax laws. Only sales or exchanges in the "ordinary course of business" will be considered adequate and full consideration in money or money's worth.[87] For this purpose, the term "ordinary course of business" means more than normal business operations.[88] It means bona fide, arm's-length transactions made in the ordinary course of business that are free of donative intent.[89] A car dealer, for example, who sells a car listed at $10,000 to a customer for $9000 has not made a gift; nor has a butcher who sells meat at or below cost as an inducement to customers to

81. *Id.*
82. I.R.C. § 2512(b).
83. Steinkamp, *supra* note 28, at 114.
84. *See, e.g.*, Weller v. Commissioner, 38 T.C. 790 (1962).
85. LOWNDES ET AL., *supra* note 73, at 646.
86. PEAT & WILLBANKS, *supra* note 65, at 36.
87. Treas. Reg. § 25.2512-8 (as amended in 1992).
88. LOWNDES ET AL., *supra* note 73, at 646.
89. Treas. Reg. § 25.2512-8 (as amended in 1992).

patronize the store.[90] The negotiated sale of inventory to strangers is precisely what is meant by the term "ordinary course of business."

Business transactions between family members are presumed not to be in the ordinary course of business.[91] Because family members are natural objects of the taxpayer's bounty, the issue is whether the transaction is free of donative intent.[92] Courts will closely scrutinize family transactions to ensure that they are bona fide, especially when the property transferred has no readily ascertainable fair market value.[93] The sale of the car, mentioned above, which was listed for $10,000 to a customer for $9000 may very well be a gift if the buyer and seller are closely related.[94]

3. Support

The gift tax does not apply to transfers in satisfaction of an obligation of support.[95] It is generally accepted that a gratuitous transfer of property from a parent to a minor child is not a taxable gift so long as the transfer is in discharge of a legal obligation imposed upon the transferor to provide support for the child.[96] While this position is virtually a truism, there is little authority for it in the I.R.C.[97] "Presumably the proposition that one does not incur a gift tax liability by supporting a spouse and children in an

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90. PEAT & WILLBANKS, *supra* note 65, at 30-31.

91. Kass v. Commissioner, 33 T.C.M. (CCH) 239 (1974). For example:

> Father, F, sold 1,000 shares of XYZ, Inc. common stock to his daughter, D, for $10 per share on a day when the mean price of the stock on an established exchange was $25 per share. F made a gift to D of $15 per share--the difference between the mean price of $25 per share and the price he received. The transaction was part sale, part gift, and not a bona fide business transaction . . . .

PRICE, *supra* note 24, at 100.

92. PEAT & WILLBANKS, *supra* note 65, at 33.

93. *Id.* *See also* BOWE, *supra* note 22, at 23-24 ("Wherever the sale is made to a member of the seller's family or one who would be a natural object of his bounty (i.e., any transaction other than an arm's-length business contract) and the price received is less than the fair market value of the property transferred, a gift tax will be imposed on the difference in value between what was given and what was received.").

94. *See, e.g.*, Small v. Commissioner, 28 T.C.M. (CCH) 1111 (1969).

95. Steinkamp, *supra* note 28, at 114. One author aptly summed up the support exception by encouraging taxpayers to squander their assets. "Be not only generous but a spendthrift. That is the way to beat the federal taxes imposed on gratuitous shifting of interests in property." STEPHENS ET AL., *supra* note 55, at 1-2.

96. David Beck & Sheldon V. Ekman, *Where Does Support End and Taxable Gift Begin?*, 23 INST. ON FED. TAX'N 1181 (1965).

97. *Id.*

amicable family setting was thought so obvious as not to require an explicit statement."[98] Yet this was not always the case. The proposed regulations released after the enactment of the 1954 I.R.C. provided that "current expenditures by an individual on behalf of his spouse or minor child in satisfaction of his legal obligation to provide for their support are not taxable gifts."[99] Although no longer expressed in the regulations, this principle continues to be recognized.[100]

What is included within the obligation of support? The extent and value of the support obligation must be ascertained from the facts and circumstances of each case.[101] The extent of the support obligation is a matter of local law, which in many jurisdictions depends on the obligor's earning ability, means, situation, and condition in life.[102] Certainly, the "necessaries" (food, clothing, shelter, etc.), as defined by the law of contract, are considered to be support obligations and thus free of gift taxation.[103] Support, however, is more inclusive than the necessaries.[104] Indeed, "[m]ost amounts expended on behalf of persons owed support will not be subject to the gift tax because of the support obligation."[105] One author defined payments in discharge of the support obligation as those transfers that do not "build-up wealth" for the donee.[106]

Fortunately, most of the difficult issues involving the support obligation have been averted by the enactment of various gift tax provisions.[107] For example, nearly all transfers between spouses are now free of gift tax,[108] as are most transfers resulting from divorce or separation.[109] In addition, there is no longer any question that an obligor can pay the college tuition or medical

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98. BORIS I. BITTKER & ELIAS CLARK, FEDERAL ESTATE AND GIFT TAXATION 73 (1990).

99. Treas. Reg. § 25.2511-1(f)(1) (proposed 1957).

100. STEPHENS ET AL., *supra* note 55, at 10-51.

101. Treas. Reg. § 25.2511-1(f)(1) (proposed 1957).

102. Steinkamp, *supra* note 28, at 115.

103. Hill v. Commissioner, 88 F.2d 941 (8th Cir. 1937).

104. *See, e.g.*, Sue A. Wyskiver, Note, *The Federal Income Tax Consequences of the Legal Obligation of Parents to Support Children*, 47 OHIO ST. L.J. 753, 759-66 (1986).

105. Steinkamp, *supra* note 28, at 115.

106. A. James Casner, *Proposed Tax Changes and Their Effect on Estate Planning*, THIRD ANN. INST. ON EST. PLAN. 9-3 (1969).

107. *Id.* at 9-1.

108. I.R.C. § 2523.

109. I.R.C. § 2516 (a settlement of marital or property rights between husband and wife, when divorce occurs within two years of a written agreement establishing the settlement, is treated as a transfer for an adequate consideration and not as a gift); Adams, *supra* note 13, at 142-44.

expenses of an adult child without exposure to gift tax.[110] And most importantly, the $10,000 annual exclusion exempts most other support payments from gift taxation.[111]

4. Gratuitous Services

Not every gratuitous transfer is subject to gift tax.[112] "For the gift tax to be imposed there must be a transfer of at least one property right, and the transfer of services is not considered to be a transfer of a property right."[113] "[T]axpayers with substantial talent or technical knowledge can transfer enormous wealth to their children through the rendering of gratuitous services and yet avoid the gift tax."[114]

For instance, in *Commissioner v. Hogle*,[115] the taxpayer, a professional stock broker, established several trusts for the benefit of his children. The taxpayer retained the right to manage the securities that he had transferred to the trust. As a result of his expertise, the taxpayer was able to significantly increase the value of the trusts. The I.R.S. maintained that the taxpayer's service to the trusts was a taxable gift, but the court disagreed, concluding that the rendering of investment advice was not a gift to the trusts because no property was transferred by the taxpayer. Congress has, according to the court, chosen to tax "property" transferred by gift, not services.[116]

B. *Advantages and Disadvantages of Gifts*

In 1976, Congress integrated the gift and estate taxes in an attempt to treat both types of gratuitous transfers alike. Yet, there remain several advantages to disposing of wealth during life.[117] First, and most important, is the $10,000 annual exclusion from gift tax for which there is no estate tax equivalent.[118] Second, the gift tax is tax-exclusive (no tax assessed on the tax payment itself), while the estate tax is tax-inclusive (tax assessed on the property

110. I.R.C. § 2503(e). *See also* Milton L. Ray, *The Transfer for Consumption Problem: Support and the Gift Tax*, 59 OREGON L. REV. 425 (1981).

111. I.R.C. § 2503(b).

112. PEAT & WILLBANKS, *supra* note 65, at 50.

113. *Id.*

114. *Id.* at 51. *See also* Randall J. Gingiss, *The Gift of Opportunity*, 41 DEPAUL L. REV. 395 (1992).

115. 165 F.2d 352 (10th Cir. 1947).

116. *Id.* *See also* PEAT & WILLBANKS, *supra* note 65, at 53.

117. Of course, there are many non-tax considerations in deciding whether to make gifts. *See, e.g.*, Frederick R. Keydel, *Practical Suggestions for Lifetime Gifts Outright and in Trust*, *in* ESTATE PLANNING IN DEPTH 373, 382-83 (2d ed. 1974).

118. I.R.C. § 2503(b).

transferred as well as the tax payment itself).[119] Third, if a taxpayer makes a gift of property that is likely to appreciate in value, the future gain will be experienced by the donee, not the donor.[120] Often the donee will be in a lower marginal income tax bracket than the donor.[121] Indeed, some property, such as life insurance policies, naturally becomes more valuable each year.[122] Hence, the longer the transferor waits to dispose of such assets, the higher the taxable gift.[123] Fourth, in some cases the donor can reduce his or her income taxes by transferring income-producing property to others.[124] Fifth, payments of a donee's college tuition and medical expenses made by the transferor during life are free of gift tax, while those same payments made at death may be subject to estate tax.[125] Finally, assets transferred prior to death are not subject to formal probate administration.[126]

On the other hand, there are some potential disadvantages to inter vivos gifts.[127] First, if the property has already appreciated in

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119. On gifts made within three years of death the gift tax paid is brought back into the gross estate in a process known as "grossing-up." Leimberg, *supra* note 12, at 8.3; Harrison, *supra* note 7, at 384-85.

120. Frederic G. Corneel & John K. Graham, *Lifetime Gifts*, *in* SOPHISTICATED ESTATE PLANNING TECHNIQUES 589 (1984). The authors provide the following example:

> Assume a donor with an estate currently valued at $1,000,000 consisting of an asset now valued at $325,000 but expected to double in value by the date of death and the balance in assets not expected to appreciate. By giving away the asset expected to appreciate, the donor will by able to save $134,750 [1984 tax rates] in total transfer taxes (estate and gift tax).

121. David Beck, *How to Make Effective Gifts to Minors*, *in* 1 EST. TAX TECHNIQUES 9-7 (1985); HOLZMAN, *supra* note 47, at 46.

122. A. JAMES CASNER & ROBERT A. STEIN, ESTATE PLANNING UNDER THE TAX REFORM ACT OF 1976, at 75 (2d ed. 1978) ("This suggests that the subject matter of lifetime gifts should be items that are most likely to show a significant depreciation over the years. One item that has this characteristic is life insurance which has the added attraction that it is not subject to the carryover basis rules when the proceeds are collected as a result of the death of the insured.") *See also* RAPKIN, *supra* note 17, at 5-16 ("While cash or cash-equivalent gifts are attractive assets to transfer under the annual exclusion because of the ease in valuation and divisibility among many beneficiaries, this type of asset is less appealing as an estate freeze candidate. More useful is growth-oriented stock, real estate, collectibles or other appreciating assets.").

123. HOLZMAN, *supra* note 47, at 44.

124. Unearned income of a child under the age of 14 is taxed at the parent's highest marginal rate in case of transfers made after March 1, 1986. *See generally id.* at 57-58; Patti S. Spencer, *Advantages Remain to Making Gifts in Trust to Minors that Qualify for Annual Exclusion*, 14 EST. PLAN. 264 (1987).

125. I.R.C. § 2503(e).

126. Lifetime gifts may also reduce the donor's ultimate probate expenses. *See* RAPKIN, *supra* note 17, at 5-15.

127. *Id.*

value, it may be best to transfer the property at death. In such cases, the donee will receive the "stepped-up" basis (fair market value at time of death) for income tax purposes.[128] The income tax savings from the stepped-up basis may more than offset the estate tax burden. Second, if the property is eligible for an income tax loss and has declined in value in the hands of the donor, it may be preferable for the donor to sell the property, realize the loss, and then transfer the cash to the donee.[129] Otherwise, the loss may be squandered.[130] Third, the donor loses the use of any money transferred as a gift, money that may be needed in the donor's later years.[131] No one can estimate his or her life span, not to mention the amount necessary for support during retirement.[132] Finally, a donor should not make gifts in excess of the annual exclusion after he has used up his entire unified credit. To do so would be the equivalent to prepaying estate taxes.[133] All things considered, however, it is usually preferable to transfer property during life rather than waiting until death.

C. *Net Gifts*

The donor is primarily liable for the gift tax resulting from a gratuitous transfer.[134] Because of the prospect of paying federal gift tax, a potential donor may be deterred from making a gift.[135] One way to overcome this dilemma is to make a net gift.[136] A net gift occurs when the donor transfers property on the condition that the donee pay any resulting gift tax.[137] The payment of gift tax

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128. I.R.C. § 1014.

129. JEROME A. MANNING, ESTATE PLANNING 142-43 (1980).

130. I.R.C. § 1015. *See also* Keydel, *supra* note 117, at 390-91.

131. STEPHENS & MAXFIELD, *supra* note 29, at 282; MANNING, *supra* note 129, at 139 ("A client should be discouraged from disposing of significant assets that may be needed for many contingencies: the spiraling cost of living, medical expenses and other emergencies.").

132. WILLIAM C. CLAY, JR., ESTATE PLANNING AND ADMINISTRATION 91-92 (3d ed. 1979) ("[A] donor should not make gifts that will reduce his estate below the level needed for the support of himself and his wife. Occasionally, a donor will need to be reminded that he will need income from investments after his retirement, and that either he or his wife may suffer a long and expensive illness.").

133. HOLZMAN, *supra* note 47, at 47.

134. Treas. Reg. § 25-2511-2(a). The donee has secondary liability for the tax.

135. HOLZMAN, *supra* note 47, at 64.

136. *See generally* Corneel & Graham, *supra* note 120, at 609-10; CANTOR & FRANKLIN, *supra* note 12, at 144-46.

137. PEAT & WILLBANKS, *supra* note 65, at 40; Keydel, *supra* note 117, at 384-90.

must be an express condition of the gift; otherwise, it is assumed that the donor retains primary liability for the gift tax.[138]

The net gift is computed by reducing the gross value of the gift by the amount of the tax the donee must pay; the gift tax actually paid is based on the remainder.[139] A determination of the amount of tax owed by the donee requires the use of an algebraic computation. One commentator explained this complex formula as follows:

The tax on a gift of $100,000 is $23,800. But under the net gift theory, the amount of the gift is not $100,000, but only $76,200. The tax on a gift of $76,200 is not $23,800, but is only $17,212. This means that the gift is not really $76,200, but rather $82,788. The tax on a gift of $82,788 is not $17,212, and so on.[140]

Fortunately, assistance with this calculation is provided by the Internal Revenue Service (hereinafter I.R.S.).[141]

In addition, there are income tax consequences to net gifts.[142] When the donee pays the gift tax, the donor is enriched by the amount of the tax.[143] Payment of the gift tax by the donee relieves the donor of indebtedness, and relief from debt is income to a solvent taxpayer.[144] Hence, the donor has income to the extent the gift tax paid by the donee exceeds the donor's adjusted basis in the transferred property. For example, if a person transfers a parcel of land with an adjusted basis of $15,000 to a donee on the express condition that the donee pay the gift tax imposed on the transfer, the transferor will realize income to the extent the gift tax paid by the donee exceeds $15,000. The transfer is treated, in effect, as a part-sale and part-gift.[145]

III. THE ANNUAL EXCLUSION

Section 2503(b) provides that "[i]n case of gifts (other than gifts of future interests in property) made to any person by the donor during the calendar year, the first $10,000 of such gifts to such

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138. HOLZMAN, *supra* note 47, at 66-67 (One transfer was considered to be a net gift where the donees signed letters prepared by the donor's lawyer, stating: "We have further been informed that this gift is being made subject to my paying the gift tax on same. This letter can be taken as my acceptance of the proposed condition of the gift, and I agree to accept as my share of the gift tax an amount computed by your tax counsel.").

139. *Id.* at 65.

140. PEAT & WILLBANKS, *supra* note 65, at 41.

141. *Id.*

142. *See, e.g.*, Diedrich v. Commissioner, 457 U.S. 191 (1982).

143. PEAT & WILLBANKS, *supra* note 65, 144.

144. *Id.* at 67.

145. BITTKER & CLARK, *supra* note 98, at 101.

person shall not . . . be included in the total amount of gifts made during such year."[146] "Because the exclusion is computed on a per-donee basis, a taxpayer can give away $10,000 each to an unlimited number of donees without incurring any gift tax liability, and this process can be repeated year after year."[147] The exclusion is "annual" because the $10,000 amount is available anew each year, and it is "per-donee" because $10,000 transfers to each and every donee may be excluded by a single donor.[148] For example:

> [A]ssume the donor has three children. She can thus transfer $30,000 per year—$10,000 to each child—without incurring any gift tax consequences. And if each *child* is married, the donor can transfer an additional $30,000 per year—$10,000 to each spouse. Over a ten-year period this donor can deplete her estate by $600,000—the amount equivalent to the unified credit—without using up any of that credit or even filing a gift tax return.[149]

There is no limit on the number of donees for whom the donor may claim annual exclusions.[150] However, unused portions of the annual exclusion cannot be carried forward for use in future years, nor back for use in prior years.[151] Moreover, because the annual exclusion is calculated on a per-donee basis, an unused amount from one donee may not shifted to another donee.[152] For example, if a donor makes two gifts in a calendar year—$15,000 to his son and $5000 to his daughter—the transfers are not aggregated and wiped out by two annual exclusions.[153] Rather, the donor has made a $5000 tax-free gift to his daughter, a $10,000 tax-free gift to his son, and a $5000 taxable gift to his son.[154] The annual exclusion is one of the most significant tools available to the estate

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146. I.R.C. § 2503(b).

147. Bittker, *supra* note 17, at 448.

148. REGIS W. CAMPFIELD ET AL., TAXATION OF ESTATES, GIFTS AND TRUSTS 129 (19th ed. 1991); DUBROFF & KAHN, *supra* note 4, at 332.

149. PEAT & WILLBANKS, *supra* note 65, at 73-74; CAMPFIELD ET AL., *supra* note 148, at 130.

150. GERHART, *supra* note 18, at 10.

151. *See generally* HOLZMAN, *supra* note 47:

> Unlike charitable contributions and business losses, unutilized gift tax exclusions cannot be carried over for use in a later year's computations. So if the annual exclusion is not fully utilized in any one year, it is forfeited forever. That places a great premium upon timing. The earlier a person starts an annual gift program, the greater are the potential dollar benefits of the annual exclusion.

Id. at 49.

152. LOWNDES ET AL, *supra* note 73, at 647; SUTKOWSKI & KUPPLER, *supra* note 60, at 9.

153. *See* Bittker, *supra* note 17, at 449.

154. *Id.*

planner.[155] It can be used to transfer incredible amounts of wealth from generation to generation free of transfer tax.[156]

A. *History of the Annual Exclusion*

The short-lived 1924 gift tax contained an annual per-donor exclusion of $50,000, as well as an annual per-donee exclusion of $500.[157] Since 1932, however, the gift tax has contained only an annual per-donee exclusion.[158] The 1932 annual per-donee exclusion was set at $5000.[159] The $5000 exemption was in effect until 1938, when Congress reduced it to $4000 because of "the frequency with which donors are induced by the exemption to build up estates of considerable size for members of their families."[160] In 1942, the exclusion was once again reduced to prevent estate tax avoidance:

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155. Leimberg, *supra* note 19, at 42-2; CAMPFIELD ET AL., *supra* note 148, at 130 ("Continued and carefully planned use of the exclusion provides a ready vehicle for transfer of large amounts to younger generations without a tax burden of any kind."); Richard W. Harris & Steven W. Jacobson, *Maximizing the Effectiveness of the Annual Gift Exclusion*, 70 TAXES 204 (1992).

156. Leimberg, *supra* note 19, at 42-1; CLAY, *supra* note 132, at 92 ("a donor can achieve almost unbelievable tax savings" with proper usage of the annual exclusion).

157. Revenue Act of 1924, Pub. L. No. 68-176, §§ 319-324, 43 Stat. 253, 313-316.

158. From 1932 to 1938, no exclusion was permitted for gifts of future interests. From 1939 to 1942, the denial of the exclusion was extended to all gifts in trust. From 1943 to 1954, the statute reverted to the original rule, and denied the exclusion only for gifts of future interests. Since 1954, the exclusion has been denied for future interests but with a liberalization of the future interest rule for gifts to minors. JACOB RABKIN & MARK H. JOHNSON, 4 FEDERAL INCOME, GIFT AND ESTATE TAXATION 51-67 (1993).

159. S. REP. NO. 72-665, at 41 (1932), *reprinted in* 1939-1 (Part 2) C.B. 496, 525-26.

160. H. REP. NO. 75-1860, at 61 (1938), *reprinted in* 1942-2 (Part 2) C.B. 372, 403. The Treasury Regulations then in effect explained the modification as follows:

> Except with respect to any gifts in trust or a future interest in property, the first $4,000 of gifts made to any one donee during the calendar year 1939 or during any calendar year thereafter shall be excluded in determining the total amount of gifts for such calendar year. Except with respect to any gift of a future interest in property, the first $5,000 of gifts made to any one donee during the calendar year 1938 or during any calendar year prior thereto shall be excluded in determining the total amount of gifts for such calendar year. The entire value of any gift made by a transfer in trust after December 31, 1938, and the entire value of any gift of a future interest in property, must be included in the total amount of gifts for the calendar year in which such a gift is made.

Treas. Reg. § 79 (1936).

> Since this is an annual exclusion (not exhaustible as is the specific exemption) and is not limited to any number of donees, it is possible to distribute property of large aggregate value over a number of years, free not only of gift tax but of estate tax as well. [However,] administrative difficulties prevent the abolition of the exclusion . . . .[161]

As a consequence of this abuse, Congress reduced the exclusion to $3000, where it remained until 1981. In 1981, the annual exclusion was increased to $10,000 to reflect the reduced purchasing power of the dollar.[162]

1. Split Gifts

A married donor can, with his or her spouse's consent, transfer $20,000 annually to each of as many donees as he or she pleases.[163] Section 2513 treats such gifts as if made one-half by the donor and one-half by the donor's spouse.[164] As a consequence, a donor with four children and six grandchildren can transfer a total of $200,000 per year to her descendants, as long as her spouse consents to the gifts.[165] Over a ten-year period, the donor can transfer two million dollars to her descendants, free of gift, estate, and generation-skipping taxation.[166]

Gift-splitting was established by Congress in 1948 in an effort to equalize the gift tax treatment in community property and common law states.[167] In community property states, gifts made by a married couple were, as a matter of state law, considered as made one-half by each spouse. Section 2513 provides this same

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161. H. REP. NO. 77-2333, at 37 (1942), *reprinted in* 1942-2 (Part 2) C.B. 372, 403.

162. UNITED STATES JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF THE ECONOMIC RECOVERY TAX ACT OF 1981, at 273 (1981). *See also* L. Henry Gissel, Jr., *Lifetime Transfers After 1981*, *in* 1 ESTATE PLANNING IN DEPTH 273 (American Law Institute ed. 1982):

> For purposes of estimating the effect of inflation upon the annual gift tax exclusion, we compared the Consumer Price Index ("CPI") for July of 1942 with that of the corresponding month in 1981. On the basis that 1967 = 100, the July 1942 CPI was 49.0 and the July 1981 CPI was 274.6. The 225.6 difference amounts to a 460% change during that period. Using these figures, the $3,000 annual exclusion in 1942 restated in 1981 dollars amounts to $13,920. Conversely, the $10,000 annual exclusion under ERTA would amount to only $2,171 in 1942 dollars.

Id.

163. I.R.C. § 2513.

164. PEAT & WILLBANKS, *supra* note 65, at 75.

165. PRICE, *supra* note 24, at 108-09. Gift-splitting is also recognized by the generation-skipping tax. I.R.C. § 2652(a)(2).

166. *See generally* Harris & Jacobson, *supra* note 155, at 205.

167. STEPHENS ET AL., *supra* note 55, at 10-60.

treatment for gifts made by married couples living in separate property states.[168] Of course, now that there is an unlimited marital deduction,[169] couples can achieve this same objective through a series of tax-free transfers: the donor transfers $10,000 to his or her spouse tax-free and then each spouse transfers $10,000 to the intended beneficiary.[170]

Gift-splitting is only available if both spouses are either citizens or residents of the United States.[171] The couple must be married at the time of the gift, and both spouses must consent to split all gifts made during the calendar year. If gift-splitting is elected, both spouses have joint and several liability for any gift tax resulting from the transfer, even though only one of them provided the funds for the gift.[172] A gift tax return must be filed for all split-gifts.[173]

2. Timing of Gifts

It is common practice for estate planners to persuade clients to make a series of $10,000 gifts ($20,000 for couples) near the end of the calendar year. Quite often, this occurs in late December. The $10,000 gifts are usually made in the form of personal checks and are delivered to the donees just before the end of the calendar year. It is not uncommon for the donees to wait until the following year to cash the checks. Such delay may have detrimental

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168. PEAT & WILLBANKS, *supra* note 65, at 75.

169. I.R.C. § 2523.

170. *See, e.g.*, CAMPFIELD ET AL., *supra* note 148, at 130.

171. *See generally* HOLZMAN, *supra* note 47, at 51. To qualify for gift-splitting, the following prerequisites must be satisfied:

> (1) The donor must be married at the time of the gift;
> (2) Neither the donor nor the spouse may remarry during the year of the gift;
> (3) Both spouses are U.S. citizens or residents at the time of the gift;
> (4) The gift is to someone other than the spouse;
> (5) The donor may not create a general power of appointment over the transferred property that is exercisable by the spouse, pursuant to I.R.C. Section 2514(c); and
> (6) A consent by the spouse is timely filed and not revoked.

RAPKIN, *supra* note 17, at 5-20.

172. Treas. Reg. § 25.2511-1(d) (as amended in 1972).

173. David K. Carlson, *Economic Recovery Tax Act Raises Credit, Cuts Rates, Among Myriad Estate and Gift Changes*, *in* 8 ESTATE PLANNING 322 (1981) ("Since gift-splitting is elective, a gift tax return is required to signify the electing spouse's consent even though the exclusion will avoid any tax."). If each spouse makes the gifts from his or her own resources, so that § 2513 need not be used, no gift tax return will be required for annual exclusion gifts. CAMPFIELD ET AL., *supra* note 148, at 130.

consequences for the donor, as he or she may inadvertently make two $10,000 gifts to the same donee in the same calendar year.[174]

The I.R.S. and the courts have held that a gift made by personal check is not complete for gift tax purposes until the check is cashed.[175] Before it is cashed, the donor has not relinquished control over the gift because he or she could stop payment on the check.[176] It is immaterial that a check is often treated as cash for income tax purposes.[177] In a recent decision, however, the Tax Court allowed a taxpayer to claim the annual exclusion for checks delivered to the donees on December 31, 1985, but not paid by the bank until January 2, 1986.[178] The Tax Court concluded that the checks related back to the date of delivery. As such, the checks were treated as complete gifts in 1985.

B. *Purpose of the Annual Exclusion*

Congress has advanced three reasons for the annual exclusion. Two of these reasons were announced at the time of the enactment of the $5000 annual per-donee exclusion in 1932: "Such exemption, on the one hand, is to obviate the necessity of keeping an account of, and reporting, numerous small gifts, and, on the other, to fix an amount sufficiently large to cover in most cases wedding and Christmas gifts and occasional gifts of relatively small amounts."[179] In addition to these two justifications, Congress has stated that the annual exclusion is intended to serve as an incentive for making lifetime transfers.[180]

The current $10,000 annual exclusion is inconsistent with at least two of these reasons. First, if the annual exclusion were truly designed to obviate the necessity of keeping an account of and reporting numerous small gifts, as Congress declared in 1932, then $10,000 is far too excessive. Not many U.S. citizens would consider annual gifts to a single donee of $10,000 to be "small," nor would most people find it tedious to account for such gifts. More importantly, the annual exclusion not only covers gifts of less than $10,000 to a single donee, it also exempts the "first $10,000" of

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174. *See, e.g.*, Estate of Dillingham v. Commissioner, 903 F.2d 760 (10th Cir. 1990) (annual exclusion denied where donees inexplicably delayed presenting checks for payment for more than 30 days after end of calendar year).

175. Rev. Rul. 67-396, 1967-2 C.B. 351.

176. *Id.*

177. Kahler v. Commissioner, 18 T.C. 31 (1952).

178. Estate of Metzger v. Commissioner, 100 T.C. 204 (1993), *aff'd*, 38 F.3d 118 (4th Cir. 1994).

179. H.R. REP. NO. 72-708, (1932), *reprinted in* 1939-1 C.B. (Part 2) 457, 478; S. REP. NO. 72-665 (1932), *reprinted in* 1939-1 C.B. (Part 2) 496, 525-26.

180. H.R. REP. NO. 94-1380 (1976), *reprinted in* 1976-3 C.B. 735, 746.

larger gifts made to a single donee.[181] If the justification for the annual exclusion is the elimination of the record keeping requirements for small gifts, this justification disappears once the gifts to a single donee exceed the annual exclusion amount and a gift tax return must be filed in any event.[182]

"The second reason given for the annual exclusion is its true justification. Customary and occasional gifts of relatively small value should be allowed without triggering the gift tax."[183] Any sensible gift tax must exempt small gifts from taxation.[184] This belief is universally recognized. Otherwise, taxpayers would ignore the tax, undermining the voluntary basis on which the gift tax system depends.[185] In short, the only legitimate justification for the annual exclusion is to exempt occasional small gifts from taxation.[186] None of the other justifications is tenable.

The third reason for the annual exclusion contradicts the unified nature of the transfer tax system:

> The argument for encouraging lifetime gifts is that such transfers pass new wealth to the next generation, thus avoiding "locking in" of investments and promoting the employment of capital in riskier ventures, but there is really no empirical data to support this conclusion. Even if we accept it as true, we must ask whether the benefit outweighs the cost of a high level of annual exclusion and the unfairness inherent in allowing wealthy taxpayers yet one more benefit that is not realistically available to all taxpayers.[187]

Vertical tax inequity—*i.e.*, the disparate treatment of taxpayers at different income levels—exists unless the same tax benefits are available to all taxpayers, something absent from the annual exclusion. Moreover, if Congress wishes to avoid the "locking-in" of capital there are better ways to achieve this goal. For example, Congress could abolish the "stepped-up" basis provisions of I.R.C. Section 1014.[188] This would "unlock" a considerable amount of capital.[189] Further, the third justification also contradicts the basic purpose of the gift tax: to serve as a backstop to the estate tax.

Everyone agrees that some form of annual exclusion is necessary to maintain a sensible gift tax system. Ideally, the

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181. *See generally* RABKIN & JOHNSON, *supra* note 158, at 51-67.

182. STANLEY SURREY ET AL., FEDERAL WEALTH TRANSFER TAXATION 682 (1987); Steinkamp, *supra* note 28, at 117. Once the $10,000 threshold is surpassed, a gift tax return must be filed. RAPKIN, *supra* note 17, at 5-17.

183. Steinkamp, *supra* note 28, at 117-18.

184. PEAT & WILLBANKS, *supra* note 65, at 92.

185. *Id.*

186. Steinkamp, *supra* note 28, at 118.

187. PEAT & WILLBANKS, *supra* note 65, at 94.

188. *See generally* Russell K. Osgood, *Carryover Basis Repeal and Reform of the Transfer Tax System*, 66 CORNELL L. REV. 297 (1981).

189. *See generally* Dodge, *supra* note 13, at 335-39.

annual exclusion should be sufficient in amount to exempt most customary gifts from taxation, yet modest enough to safeguard the estate tax protective function of the gift tax. But is there a form of annual exclusion preferable to the $10,000 annual per-donee exclusion? As shown below, the answer is an emphatic "yes."

C. *Present and Future Interests*

The annual exclusion is not available for gifts of future interests.[190] Rather than attempt to set up many fine-line distinctions, Congress chose to deny the annual exclusion to all gifts of future interests in property.[191] Accordingly, the entire value of a gift of a future interest in property must be included in the taxable gifts for the calendar year in which the gift is made.[192]

Congress denied any exclusion for future interests because of "the apprehended difficulty, in many instances, of determining the number of eventual donees and the values of their respective gifts."[193] Determining whether an interest in property is future or present, however, is no easy task.[194] No gift tax provision has caused more confusion nor resulted in more litigation.[195] Professor Bittker aptly summed up this complexity when he stated that "make-believe is [the] principal characteristic" of the future interest limitation.[196] Professor Bittker's conviction will prove true as one attempts to apply the future interest limitation to various property

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190. I.R.C. § 2503(b).

191. FEDERAL ESTATE AND GIFT TAXES EXPLAINED, *supra* note 64, at 397-98.

192. 2 JOSEPH RASCH, HARRIS HANDLING FEDERAL ESTATE & GIFT TAXES 328 (4th ed. 1984); CAMPFIELD, *supra* note 148, at 131.

193. S. REP. No. 72-665 (1932), *reprinted in* 1939-1 (Part 2) C.B. 496, 526. To illustrate, assume that a donor transfers property in trust to pay the income to A for life with remainder to B. Since A has the present right to receive income, the gift to him of the life income interest is a gift of a present interest. Because B does not have the right to possess or enjoy the property until a future date, the gift to him of the remainder interest is a gift of a future interest and does not qualify for the annual exclusion. GERHART, *supra* note 18, at 11.

194. If a gift of property creates both future and present interests in the transferred assets, the present interest must be valued separately in order to determine the amount of the annual exclusion that is applicable to the gift. Only the value of the present interest is subject to the exclusion. *See* DUBROFF & KAHN, *supra* note 4, at 333.

195. RASCH, *supra* note 192, at 329; PAUL, *supra* note 32, at 970-71 (courts have become enmeshed in difficulties in applying the term "future interests" to various gifts).

196. Bittker, *supra* note 17, at 463; Jeffrey G. Sherman, *'Tis a Gift to be Simple: The Need for a New Definition of "Future Interest" for Gift Tax Purposes*, 55 U. CIN. L. REV. 585 (1987).

interests.[197] Before applying the future interest limitation to particular property interests, however, one must have a general understanding of the future interest rule.

As initially adopted, the term "future interests in property" was meant to encompass "any interest or estate, whether vested or contingent, limited to commence in possession or enjoyment at a future date."[198] According to the Treasury Regulations: "'Future interests' is a legal term, and includes reversions, remainders, and other interests or estates, whether vested or contingent, 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."[199] A gift may be a future interest for gift tax purposes even though such interest is classified as a present interest under state property law. For instance, in *United States v. Pelzer*,[200] the Supreme Court held that a gift to the beneficiaries of a trust under which the income was to accumulate for ten years before being distributed to the beneficiaries was a gift of a future interest in property, despite the fact that such interest was considered a present interest under state law. The test was not whether an interest is classified as "present" under state law, but rather whether the donees has "an unrestricted right to the immediate use, possession, or enjoyment of property or the income from property."[201]

In *Pelzer*, the beneficiaries had no right to the present enjoyment of the corpus or of the income and unless they survived the ten-year period they would never receive any part of either. The "use, possession, or enjoyment" of each donee was thus postponed to the happening of a future uncertain event. The gift thus involved the difficulties of determining the "number of eventual donees and the value of their respective gifts" which it was the purpose of the statute to avoid.[202]

Any other outcome would have allowed the peculiarities of state property law to determine whether an interest is a taxable gift. This is contrary to notions of a uniform federal gift tax:

> In the absence of any statutory definition of the phrase we look to the purpose of the statute to ascertain what is intended. It plainly is not concerned with the varying local definitions of property interests or with the local refinements of conveyancing, and there is no reason for supposing that the extent of the granted tax

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197. *See also* STEPHENS ET AL., *supra* note 55, at 9-17 ("[T]he rule is applied mechanically, even in circumstances that bear little relationship to its supporting reasons, and sometimes with surprising results").

198. S. REP. NO. 72-665 (1932), *reprinted in* 1939-1 (Part 2) C.B. 496, 526.

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

200. 312 U.S. 399 (1941).

201. Treas. Reg. § 25-2503-3(b) (as amended in 1983).

202. United States v. Pelzer, 312 U.S. 399, 404 (1941).

> exemption was intended to be given a corresponding variation. Its purpose was rather the protection of the revenue and the appropriate administration of the tax immunity provided by the statute. It is this purpose which marks the boundaries of the statutory command.[203]

"It is not enough that the donee receives a vested right to the property, even an interest that he can sell; the statutory test is immediate right to use, possession, or enjoyment."[204] The fact that title has vested in the donee is immaterial.[205] Moreover, the mere power of the donee to sell an interest will not convert a future interest into a present interest, as even the most contingent remainder has some market value.[206] The terms "use, possession, or enjoyment" are not words of art, like "fee simple," but connote the right to substantial present economic benefit.[207] "The question is of time, not when title vests, but when enjoyment begins."[208]

Most outright gifts of property qualify for the annual exclusion.[209] Gifts of cash, stocks, personal property, or real estate are usually considered present interests.[210] Remainder interests, on the other hand, are future interests in property, regardless of whether they are vested.[211] A single gift can, of course, contain both present and future interests, requiring such interests to be separated for purposes of the annual exclusion.[212] Of course, the taxpayer has the burden of proving that he or she is entitled to the annual exclusion.[213] The taxpayer must prove that the gift is of a present interest and prove the amount of the exclusion to which he or she is entitled.[214]

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203. *Id.* at 403.

204. STEPHENS ET AL., *supra* note 55, at 9-17.

205. RASCH, *supra* note 192, at 330.

206. Blasdel v. Commissioner, 58 T.C. 1014, 1021-22 (1972), *aff'd per curiam*, 478 F.2d 226, 227 (5th Cir. 1973).

207. Fondren v. Commissioner, 324 U.S. 18, 20 (1945).

208. *Id.* *See also* AMERICAN BAR ASSOCIATION, FEDERAL GIFT, ESTATE AND GENERATION SKIPPING TRANSFER TAXATION OF LIFE INSURANCE 12-13 (1991).

209. PEAT & WILLBANKS, *supra* note 65, at 76.

210. *Id.* This includes outright gifts that do not bestow any immediate benefits on the donee, such as negotiable promissory notes or life insurance policies.

211. STEPHENS ET AL., *supra* note 55, at 9-17. A gift in trust of a remainder interest in personal property to a donee who is an income beneficiary of the trust is a gift of a present interest, assuming the two interests merge under state law. FEDERAL ESTATE AND GIFT TAXES EXPLAINED, *supra* note 64, at 398.

212. Fisher v. Commissioner, 132 F.2d 383 (9th Cir. 1942); Leimberg, *supra* note 12, at 8.7. In such cases, it is necessary to identify each gift in deciding the number of exclusions that may be claimed. STEPHENS ET AL., *supra* note 55, at 9-17.

213. Steinkamp, *supra* note 28, at 125.

214. *Id.*

1. Identification of Donees

Because the $10,000 annual exclusion applies to gifts made by the donor "to any person,"[215] each donee of a gift must be identified in order to determine the number of allowable exclusions.[216] One of the reasons Congress denied the exclusion for future interests was "the apprehended difficulty, in many instances, of determining the number of eventual donees . . . ."[217] If a father makes an outright gift to his living children, the number of donees is easy to determine. This is not the case, however, if the gift is made to a trust or some other legal entity.

If a donor transfers property to a trust having three beneficiaries with present interests, is the donor entitled to one annual exclusion or three? In *Helvering v. Hutchings*,[218] the Supreme Court held that the beneficiaries of a trust, and not the trust itself, are the donees for purposes of the annual exclusion.[219] Consequently, the donor in *Hutchings* was allowed an annual exclusion for each beneficiary. If the trust were viewed as the donee, then donors could avoid the gift tax by creating an unlimited number of trusts for the same beneficiary, with each trust qualifying for an annual exclusion.[220] To avoid such problems, *Hutchings* made clear that the beneficiaries of the trust were the true donees. Of course, a single transfer to a trust may qualify for several annual exclusions.[221] The number of exclusions is limited only by the number of beneficiaries and the future interest rule.[222]

Gifts to a corporation present a similar problem.[223] Is the corporation the donee, or is each shareholder a donee for purposes of the annual exclusion? Courts have consistently held that the shareholders are the true donees, each to the extent of his or her proportionate interest in the corporation.[224] This means that a gift

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215. I.R.C. § 2503(b).

216. Bittker, *supra* note 17, at 449.

217. S. REP. NO. 72-665 (1932), *reprinted in* 1939-1 (Part 2) C.B. 496, 526.

218. 312 U.S. 393 (1941).

219. Prior to *Hutchings*, some cases had held that the trust was the donee, not the beneficiaries. These cases induced Congress to eliminate the annual exclusion for all gifts in trust in 1938. With the safeguard provided in *Hutchings*, however, Congress repealed the flat prohibition on gifts in trust in 1942. *See generally* Bittker, *supra* note 17, at 449.

220. *Hutchings*, 312 U.S. at 396; HOLZMAN, *supra* note 47, at 50.

221. STEPHENS ET AL., *supra* note 55, at 9-13.

222. *Id.*

223. A gift from a corporation to an individual is treated as a gift from the shareholders. *See* Treas. Reg. § 25.2511-1(h)(1).

224. *See, e.g.*, Heringer v. Commissioner, 235 F.2d 149, 152 (9th Cir. 1956), *cert. denied*, 352 U.S. 927 (1956).

to a corporation may be treated as a gift to hundreds, if not thousands, of shareholders:

This conclusion is a mixed blessing to donors, since it means that the gift tax applies only to the portion of the gift inuring to the benefit of shareholders other than the donor, but that the interests of the donee shareholders are future interests for which no exclusions are allowable and that no exclusion is allowed for the corporation itself.[225]

The gift to the shareholders is a future interest because the shareholders do not have an immediate right to the use, possession, or enjoyment of the property.[226] The property belongs to the corporation, not the shareholders.[227] This treatment is consistent with the principle that a gift is made to the one on whom the donor confers the benefit of his donation.[228]

A gift to a partnership, on the other hand, is usually considered a gift of a present interest to each member of the partnership.[229] Similarly, a transfer of property to two donees as joint tenants or as tenants in common generally qualifies for two annual exclusions, assuming both interests are present in nature.[230] By contrast, a gift to a charitable organization is treated as a gift to the organization itself, and thus qualifies for only one annual exclusion.[231] Of course, since most gifts to charitable organizations qualify for a one hundred percent deduction,[232] the application of the annual exclusion to such gifts has only theoretical importance.

2. Indirect Gifts

Transfers may have to be realigned to determine the appropriate number of annual exclusions. This is often necessary in connection with two types of transfers. The first involves the use

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225. Bittker, *supra* note 17, at 450-51.

226. *See* Georgia Ketteman Trust v. Commissioner, 86 T.C. 91, 106 (1986).

227. *See* Rev. Rul. 71-443, 1971-20 C.B. 338.

228. *See* STEPHENS ET AL., *supra* note 55, at 9-15.

229. *See, e.g.*, Wooley v. United States, 736 F. Supp. 1506, 1508-10 (S.D. Ind. 1990) (holding that the annual exclusion is available for gifts to a partner's capital account if the partner has the unrestricted right to withdraw amounts from his capital). "Under the Uniform Partnership Act, the partners have an immediate right to withdraw the amounts in their respective capital accounts. Therefore, a gift that increases a partner's capital account constitutes a present interest." CAMPFIELD ET AL., *supra* note 148, at 132.

230. *See* STEPHENS ET AL., *supra* note 55, at 9-15. The I.R.S. has ruled, however, that a gift to a husband and wife as tenants by the entirety is a future interest with respect to the wife's interest. *See* Rev. Rul. 79-54, 1979-7 I.R.B. 14.

231. *See* Treas. Reg. § 25.2502-1(d), example (3).

232. *See* I.R.C. § 2522.

of a "strawman."[233] If the donor, for example, transfers $10,000 each to B and C with instructions to give the money to A, a single gift has occurred, and only one annual exclusion is appropriate.[234] A donor cannot do indirectly what he or she cannot do directly.[235]

The second situation involves reciprocal transfers. For example, A gives $10,000 to each of his children and to each of B's children.[236] B, in turn, gives $10,000 to each of his children and to each of A's children. Using reciprocal transfers, each child receives $20,000 tax free. At first blush, each of the transfers seems to be covered by the annual exclusion.[237] But instead of being allowed two exclusions, A should be treated as making $20,000 gifts to each of his children and B should be treated as making $20,000 gifts to each of his children.[238] Otherwise, there would be no limit on the number of annual exclusions available to creative taxpayers.[239]

3. Valuation

There are some present interests in property that do not qualify for the annual exclusion.[240] The right to the annual exclusion is not automatic.[241] The annual exclusion is not available unless the taxpayer can establish the value of an interest in property.[242] For instance, in *Smyth v. Commissioner*,[243] the taxpayers created trusts for the benefit of their children. The trusts were to continue until the youngest child reached the age of majority at which time the corpus would be distributed to the beneficiaries. Under the terms of the trusts, income was required to be distributed annually to the beneficiaries in equal shares, and the trustees had the right to sell the trust property.

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233. STEPHENS ET AL., *supra* note 55, at 9-15.
234. *See* Bittker, *supra* note 17, at 450.
235. *See, e.g.*, Heyen v. United States, 945 F.2d 359, 362 (10th Cir. 1991) (denying exclusions where a donor transferred $10,000 blocks of stock to each of 27 friends who, in turn, transferred the stock to a designated member of the donor's family).
236. *See* RASCH, *supra* note 192, at 328.
237. *See* Bittker, *supra* note 17, at 450.
238. *See id.; see also* United States v. Estate of Grace, 395 U.S. 316, 323 (1969) (stating that reciprocal transfers requires inquiry into subjective intent, especially in intrafamily transfers); Schultz v. United States, 493 F.2d 1225, 1225-26 (4th Cir. 1974) (disallowing exclusion of gifts to taxpayer's nephews and nieces where intent was to benefit his own children).
239. *See, e.g.*, Furst v. Commissioner, 21 T.C.M. (CCH) 1169, 1172-73 (1962).
240. *See* GERHART, *supra* note 18, at 13.
241. *See* RASCH, *supra* note 192, at 333.
242. *See* Polk v. Commissioner, 5 T.C.M. (CCH) 357, 358-59 (1946).
243. 2 T.C.M. (CCH) 4 (1943).

The court in *Smyth* first asked whether the income interests present in nature, thus qualifying for annual exclusions. The court answered this question affirmatively, concluding that the beneficiaries were entitled to a distribution of the income until the time the trustees might sell the property.[244] This is a present right to enjoyment. The court nevertheless disallowed the annual exclusions because the income interests were contingent upon the trustee's potential sale of the property. Such contingent interests, the court observed, have no determinable value.[245] If the value of a donee's present interest cannot be determined, the annual exclusion will not be allowed because it is not possible to determine whether it should be the full amount of the exclusion or some lesser amount.[246]

D. *Application of the Annual Exclusion to Certain Interests*

As shown above, a three-part test must be satisfied in order to claim the annual exclusion. "First, the donee must receive the immediate use, enjoyment, or possession of the property (a present interest in the property). Second, the identity of the donee must be determinable. Third, the value of the gift must be ascertainable at the time of the gift."[247] Although simple in form, this test has proven virtually impossible to apply, especially in close cases. As a result, the courts have been called upon far too often to ascertain which interests are future and which are present. Application of the future interest rule frequently devolves into a game of semantics, in which form controls over substance, often producing extreme results.[248] All of this can be averted, however, with sensible annual exclusion reform. This article proposes a reform measure that abolishes the distinction between present and future interests, creating a fairer and simpler tax system. Before one can

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244. *See id.* at 71.

245. The value of a gift is measured as of the date of the gift. *See* FEDERAL ESTATE AND GIFT TAXES EXPLAINED, *supra* note 64, at 372. Other examples of interests that are not capable of valuation are (1) a trust in which the trustee is required to distribute income at least annually but has uncontrolled discretion to allocate the income among several beneficiaries, Treas. Reg. § 25.2503-3(c), example 3 and (2) a trust in which the corpus can be invaded for the benefit of persons other than the income beneficiary, Funkhouser's Trusts v. Commissioner, 275 F.2d 245, 46-47 (4th Cir. 1960), *cert. denied*, 363 U.S. 804 (1960).

246. *See* RASCH, *supra* note 192, at 333. Another example of a gift of a present interest that would not qualify for the annual exclusion is an income interest in a trust under which the trustee has the power to allocate receipts and expenses between income and corpus. *See, e.g.*, Brown v. Commissioner, 30 T.C. 831, 837 (1958).

247. Steinkamp, *supra* note 28, at 128-29.

248. *See* STEPHENS ET AL., *supra* note 55, at 9-18.

appreciate the need for such reform, however, one must understand the complexities and inconsistencies of the current system.

1. Interests in Income

Where an outright gift is made, no question arises as to the donee's right to immediate use, possession, or enjoyment of the property.[249] If a gift is made in trust, however, whether the donee has a right to immediate use, possession, or enjoyment of the property depends upon the terms of the trust instrument.[250] The gift of a remainder interest in a trust is a future interest.[251] By contrast, the gift of an immediate right to the income of a trust usually constitutes a present interest qualifying for the annual exclusion.[252] This is true regardless of whether the income interest is to last for the life of the donee or for some lesser period.[253] In *Charles v. Hassett*,[254] the court explained the reason why an income interest in a trust is considered a present interest:

> [T]he answer is that historically lawyers have treated gifts of income beginning at once and lasting for life, or for a period of years, as a "present interest" and gifts of principal at a future date as a "future interest"; that Congressional committees and the Treasury appear to have had some such distinction in mind; and that this and other circuits in construing the gift tax statute have used that line of distinction in cases where the gifts of income and of principal were to different persons.[255]

To qualify for the annual exclusion, the income of the trust is required to be paid to the donee at once and not postponed to a future time.[256] An initial delay in the date the income interest takes effect, even for only a short period, will disqualify the income interest.[257] This does not mean that all of the income must be paid to the donee at the time of the gift; it only means that the donee

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249. *See* HOMER I. HARRIS, HANDLING FEDERAL ESTATE AND GIFT TAXES 655 (1959).

250. *See id.*

251. *See, e.g.*, Rev. Rul. 54-401, 1954-2 C.B. 320; RABKIN & JOHNSON, *supra* note 158, at 51-70 (both vested and contingent remainders are future interests for gift tax purposes).

252. *See* Treas. Reg. § 25.2503-4(c); CAMPFIELD ET AL., *supra* note 148, at 131.

253. *See* HARRIS, *supra* note 249, at 655.

254. 43 F. Supp. 432 (D. Mass. 1942).

255. *Id.* at 434-35.

256. *See id.* at 435.

257. *See, e.g.*, Hessenbruch v. Commissioner, 178 F.2d 785, 787 (3d Cir. 1950); *see also* Sherman, *supra* note 196, at 592-94 ("[I]t has come to be understood that the slightest degree of postponement of enjoyment will disqualify an income interest for present interest treatment.").

must have the immediate "right" to the current and future income of the trust.[258] If the donor transfers the right to a fixed percentage of the income, the gift constitutes a present interest in the amount of that percentage multiplied by the actuarial value of the entire income interest,[259] however, if the right to the income is contingent upon the donee surviving to a particular age or upon the act of some other person, the gift is a future interest.[260]

"[T]he allowance of an exclusion for gifts of income interests must bow to the normal powers of fiduciary administration, even if they impose minor restrictions on the donee's immediate access to the income from the transferred property."[261] Furthermore, the fact that the interest is subject to a spendthrift clause,[262] or that the trustee is given "judicially reviewable powers to allocate receipts between principal and interest" will not disqualify the interest for the annual exclusion.[263] On the other hand, if the trust is revocable, the gift of an income interest is incomplete; however, there is a gift of a present interest in each year in which income is paid to the donee.[264]

If a trust provides for the accumulation of income, there is no right to immediate use of the income and thus there is no present interest.[265] The same holds true if unspecified amounts of the trust income may be used for purposes other than for the benefit of the donee.[266] Moreover, the annual exclusion will be denied to an income interest if the trustee is given unfettered discretion to withhold income from the beneficiary:

> If the trustee's discretion is subject to an enforceable external standard such as a provision requiring distribution of sufficient income to maintain

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258. Bittker, *supra* note 17, at 453.

259. *See* CAMPFIELD ET AL., *supra* note 148, at 131. By contrast, if the donor directs that a fixed dollar amount be paid each year, the income interest will not qualify for the annual exclusion. *See* Estate of Kolker v. Commissioner, 80 T.C. 1082, 1089 (1983).

260. *See, e.g.*, Ryerson v. United States, 312 U.S. 405, 408-09 (1941); *Pelzer*, 312 U.S. at 402-04.

261. Bittker, *supra* note 17, at 454; *see also* RASCH, *supra* note 192, at 338 (allowing an exclusion where trustee had the power (1) to elect either the cash basis or accrual basis of accounting; or (2) to determine manner of distributing the annual income).

262. *See* Charles v. Hassett, 43 F. Supp. 432, 435 (D. Mass. 1942); Crane v. Commissioner, 16 T.C.M. (CCH) 12, 13 (1957); *see also* GERHART, *supra* note 18, at 15.

263. *See* Bittker, *supra* note 17, at 454-55. Where there has been a transfer of an income interest to a donee, the possibility that such interest may be diminished by the exercise of a power of invasion shall be disregarded in applying the annual exclusion as long as no part of such interest will at any time pass to any other person. *See* I.R.C. § 2503(b).

264. *See* Roeser v. Commissioner, 2 T.C. 298, 300-05 (1943).

265. *See Fondren*, 324 U.S. at 24; HARRIS, *supra* note 249, at 656.

266. *See* Bittker, *supra* note 17, at 454-55.

> the beneficiary at his customary standard of living, the beneficiary's right to receive the contemplated amount is a present interest, but an exclusion may nevertheless be denied if the value of the interest is not ascertainable.[267]

For instance, in *Commissioner v. Disston*,[268] the Supreme Court denied the annual exclusion to an income interest in a trust under which the trustee was given the power to distribute income "as may be necessary for the education, comfort and support" of the beneficiaries.[269] Although the beneficiaries had immediate access to such income, the court denied the exclusion:

> The existence of a duty so to apply the income gives no clue to the amount that will be needed for that purpose, or the requirements for maintenance, education and support that were foreseeable at the time the gifts were made. In the absence of some indication from the face of the trust or surrounding circumstances that a steady flow of some ascertainable portion of income to the minor would be required, there is no basis for a conclusion that there is a gift of anything other than for the future.[270]

However, if the taxpayer can show that a steady flow of income will be required to meet the trustee's obligation, the interest may qualify for the annual exclusion.[271]

Should income interests qualify for the annual exclusion? The annual exclusion was designed to exempt occasional small gifts from taxation, such as Christmas, birthday, and wedding presents. Is it common to make such gifts in the form of a trust? Or are trusts being used to evade estate taxes? These issues have troubled courts and commentators. One court noted:

> Congress, though it did not speak clearly, may have meant to exclude from the gift tax only those gifts which the donee received and was free to dispose of during the taxable year. This would allow for customary anniversary, holiday and like gifts without making it possible for the donor to escape taxation on the equivalent of a testamentary trust. Moreover, it is startling to a layman to be told that for tax purposes he has a "present interest" when all the gift is to be paid in the future and is to be paid only if he lives. And his surprise is not lessened when, as in the case at bar, he is told that although his interest has an appraised value, it has no market value because his donor, by a spendthrift trust, has made the gift unassignable and beyond the reach of creditors.[272]

All of this trouble can be avoided with sensible annual exclusion reform, as proposed in this Article.

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267. *Id.* at 455.
268. 325 U.S. 442 (1945).
269. *Id.* at 447-49.
270. *Id.* at 448-49.
271. *See, e.g.*, Morgan v. Commissioner, 42 T.C. 1080, 1088-93 (1964), *aff'd per curiam*, 353 F.2d 209 (4th Cir. 1965), *cert. denied*, 384 U.S. 918 (1966).
272. *Hassett*, 43 F. Supp. at 434.

a. Non-Income Producing Property

A present interest in property qualifies for the exclusion only to the extent that it is susceptible to valuation.[273] Although the donee may be entitled to the income from the trust, the right to income is valueless if there is no realistic expectation that income will in fact be produced.[274]

> [If] one has the right to the income from a trust for a term of years or for life, it is possible to ascribe a value to his interest with regard to the duration (term) or probable duration (life) of the right and the value of the corpus. This is what the actuarial tables prescribed by the Secretary purport to do.[275]

As one author aptly stated:

> Since the exclusion cannot exceed $10,000 or the value of the present interest to which it is applied, whichever is less, it is necessary to value income interests. This is regularly done by use of the tables prescribed by the regulations, which assume a 6 percent interest factor and, when survivorship or mortality is involved, standard actuarial data. In any individual case, of course, the property may produce a greater or lesser yield, and death may occur sooner or later than the table assumes.[276]

But should the exclusion be allowed if the donor transfers property to a trust that is not likely to produce income?[277]

The I.R.S. takes the position that the exclusion should be denied for an income interest in a trust holding non-income producing property.[278] The exclusion is denied for such interests

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273. *See* STEPHENS ET AL., *supra* note 55, at 9-20.

274. *See* CAMPFIELD ET AL., *supra* note 148, at 133; RABKIN & JOHNSON, *supra* note 158, at 51-68.

275. STEPHENS ET AL., *supra* note 55, at 9-20.

276. BITTKER & LAKKEN, *supra* note 21, at 124-1.

277. *See generally* Captain Murray B. Baxter, *Application of Section 2503(b) of the Internal Revenue Code to Gifts in Trust of Nonincome-Producing Property*, 102 MIL. L. REV. at 119, 126-32 (1983) (recommending that a donor avoid using nonincome-producing property as the corpus of a trust); *see also* Calder v. Commissioner, 85 T.C. 713, 728-30 (1985) (denying exclusion of income interest where donor transferred paintings to trust, despite the fact that the trustee was allowed to convert paintings to income-producing property).

278. *See, e.g.*, Berzon v. Commissioner, 63 T.C. 601, 514-20 (1975), *aff'd*, 534 F.2d 528 (2d Cir. 1976). The courts have not always agreed with the I.R.S. In Rosen v. Commissioner, 397 F.2d 245, 247 (4th Cir. 1968); the court stated:

> Contrary to the government's contention we think it unreasonably unrealistic to deny value to the present interest concededly possessed by the donees . . . . To deny to the taxpayers here the use of the tables is to treat, for tax purposes, the donated income interests as having no value at all.
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> . . . .
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> . . . It is important to note that it has not been suggested to us that the "income interest" was valueless. Rather the government concedes that

because the actuarial tables "are designed to calculate the value of a present interest, not to create it."[279] Indeed, the I.R.S. takes this position one step further by asserting that where a trustee is empowered to invest in non-income producing property, such as nondividend paying stock or life insurance, the income beneficiary has only a future interest.[280] The I.R.S., however, has found little support for this position in the courts:

> [T]he trust gives the donee the absolute right to all income. The fact that there may not be income during a year is not a contingency imposed by the donor. It is the right of a donee to the income, rather than the accident of whether there is income at any given time, that is the criterion of present interest. That the corpus of a trust may consist of non-interest bearing notes, payable at a future date, does not prevent a gift from being one of a present interest.[281]

Generally, a gift that does not produce current income will not qualify for the exclusion even though the trustee is expected to sell the property and reinvest the proceeds in income-producing property.[282] If, however, a donor transfers property to a trust that earns some income, but less than the amount assumed by the actuarial tables, the trust will qualify for the annual exclusion.[283] In other words, the I.R.S. allows the use of the actuarial tables to value an income interest even though the current yield from the trust property is less than normal, as in the case of growth stocks.[284]

b. Contractual Interests

Ordinarily, a present interest requires an unrestricted right to the immediate use, possession, or enjoyment of property or of the income from property. A gift of a bond, a note bearing no interest

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> a *present* income interest . . . was in fact donated. The concession seems to us near fatal. The government entertains two inconsistent positions--on one hand conceding that a valuable right was donated and on the other contending that for tax purposes the right is valueless.

Id.

279. Maryland Nat'l Bank v. United States, 609 F.2d 1078, 1081 (4th Cir. 1979).

280. Rev. Rul. 69-344, 1969-1 C.B. 225. The income-producing requirement applies only to gifts in trust. If the property is given outright to the donee, its income-producing capacity is irrelevant because the donee could sell the property for its fair market value and reinvest the proceeds. *See* CAMPFIELD ET AL., *supra* note 148, at 134.

281. Gilmore v. Commissioner, 213 F.2d 520, 522 (6th Cir. 1954); Swetland v. Commissioner, 37 T.C.M. (CCH) 249 (1978).

282. *Calder*, 85 T.C. 713.

283. STEPHENS ET AL., *supra* note 55, at 9-21.

284. Treas. Reg. § 25.2512-9.

until maturity, a life insurance policy,[285] or a similar contract is a gift of a present interest, despite the fact that the obligations thereunder are to be discharged in the future.[286] Such contracts are treated as present interests because they have a current value that can be realized by the donee before the obligations mature.[287]

Although outright gifts of such contracts are present interests,[288] the annual exclusion will be denied if such contracts are conveyed in a manner that denies the donee immediate access to the property.[289] For instance, if a life insurance policy is transferred in trust to pay the income from the property to A and the remainder to B, neither interest will qualify for the annual exclusion.[290]

Allowing an annual exclusion for non-interest bearing notes and life insurance policies is justified on the ground that "a bond or note has a present value which can be realized by the donee, apart from any income payable thereon, and even though the principal amount does not ripen into a right to payment until the future."[291] This is a flimsy justification for allowing the annual exclusion for non-interest bearing bonds while denying the exclusion for trusts holding non-income producing property:

> The difficulty with this explanation is that the mere fact that a donee can sell his interest does not mean that the interest is a present interest; for example, an indefeasibly vested remainder under a trust would probably be marketable but is assuredly a future interest. And conversely, that an interest is nontransferable does not necessarily mean that the interest is a future interest; for example, a spendthrift provision in a trust instrument, which bars the income beneficiary from assigning his income interest, does not cause the income interest to be classified as a future interest.[292]

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285. The gift of an insurance policy is not a gift of a future interest merely because the policy has no cash value. Rev. Rul. 55-408, 1955-1 IRB C.B. 113.

286. GERHART, *supra* note 18, at 17. An interest in an escrow deposit is not the kind of contractual interest that qualifies for the annual exclusion. *See* Massey v. United States, 82 USTC ¶ 13,460 (E.D. Va. 1982). If a donor pays the premiums on a previously issued life insurance policy the proceeds of which are payable to the donee, such payments are treated as present interests. Treas. Reg. § 25.2503-3(a).

287. GERHART, *supra* note 18, at 17.

288. The tax court has strictly construed the provisions in the Code that extend the scope of the annual exclusion to notes, bonds and life insurance policies. *See, e.g.*, Vose v. Commissioner, 18 T.C.M. (CCH) 1959-175, *rev'd on other grounds*, 284 F.2d 65 (1st Cir. 1960).

289. BITTKER & LAKKEN, *supra* note 21, at 124-17.

290. *Id.* A's income interest may qualify for the exclusion if the trustee can and is likely to sell the transferred property and reinvest the proceeds in income-producing property.

291. J. Krahmer & J. Burke, *Gifts-Determination of Tax*, 176-3D Tax Management Portfolio A-12 (1984).

292. Sherman, *supra* note 196, at 606-07.

This is yet another example of form overcoming substance, a practice common to the future interest rule. The distinction between non-interest bearing notes and trusts with non-income producing property is a distinction without a difference. But this can be expected in a system that thrives on the "make-believe."[293] Sensible reform, such as that proposed in this Article, will bring some reality to the world of "make-believe."

2. Gifts to Minors

Many of the difficulties with the future interest rule have arisen in the context of gifts to minors. The reasons for such problems, according to Professor Bittker, are:

> (1) donors are often reluctant to give up all strings when making gifts to young children; (2) minors are subject to legal disabilities in dealing with their assets; (3) banks, corporate transfer agents, and other institutions are often unwilling to engage in transactions with minors that may by disaffirmed when the minor reaches his or her majority; and (4) trustees and legally appointed guardians holding assets for minors ordinarily have discretionary authority either to apply the income for the minor's benefit or to accumulate it for later distribution.[294]

Because of these concerns, donors find it difficult to qualify a gift to a minor for the annual exclusion while maintaining some measure of control over the property.[295]

a. Outright Gifts

One method of transferring funds to minors is by outright gift.[296] There are, of course, practical barriers to outright transfers, especially with young donees.[297] Moreover, at one time there was a question of whether outright gifts to minors even qualified for the exclusion. In *Daniels v. Commissioner*,[298] the I.R.S. suggested that "the fact of minority and consequent legal disability of the donees resulted in the postponement of enjoyment which characterizes future interests." If this reasoning were followed, then most gifts to minors, even some Christmas presents and birthday gifts, would be

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293. Bittker, *supra* note 17, at 463.

294. *Id.* at 460.

295. *See generally* Henry J. Lischer, Jr., *Crummey Estate Planning: Successful Techniques for Gifts to Minors and Life Insurance Trusts*, 1982 INST. ON EST. PLAN. 18-13 [1982].

296. CAMPFIELD ET AL., *supra* note 148, at 134-35.

297. Lischer, *supra* note 295, at 18-13. Of course, an unrestricted gift to a minor's guardian is a present interest. RABKIN & JOHNSON, *supra* note 158, at 51-78.

298. 10 T.C.M. (CCH) 147 (1951).

characterized as future interests because the donor would retain ultimate control over the donee's enjoyment.[299] The I.R.S. backed away from this position in 1954:

> [a]n unqualified and unrestricted gift to a minor, with or without the appointment of a legal guardian, is a gift of a present interest; and disabilities placed upon minors by State statutes should not be considered decisive in determining whether such donees have the immediate enjoyment of the property or the income therefrom within the purport of the Federal gift tax law .... In the case of an outright and unrestricted gift to a minor, the mere existence or nonexistence of a legal guardianship does not of itself raise the question whether the gift is of a future interest .... It is only where delivery of the property to the guardian of a minor is accompanied by limitations upon the present use and enjoyment of the property by the donee, by way of a trust or otherwise, that the question of a future interest arises.[300]

After this announcement, it was clear that an outright gift to a minor qualified for the annual exclusion, regardless of whether a legal guardian had been appointed for the minor at the time of the gift.[301]

It is no surprise that outright gifts to minors qualify for the annual exclusion. Such customary presents are the very type of gifts for which the annual exclusion was designed. But taxpayers have not been content with outright transfers to minors. Instead, several devices have been concocted that technically qualify for the annual exclusion while allowing the donor to maintain significant control over the transferred property. A few of these devices are discussed below.

b. Demand Rights

One of the most offensive uses of the annual exclusion involves the gift of a demand right.[302] Such gifts provide the donor with the best of both worlds: a gift that qualifies for the annual exclusion,

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299. Bittker, *supra* note 17, at 460-61.

300. Rev. Rul. 54-400, 1954-2 C.B. 319.

301. *See generally* GERHART, *supra* note 18, at 19.

302. Demand rights have been a favorite topic of commentators. *See,. e.g.*, Kent Mason, *An Analysis of Crummey and the Annual Exclusion*, 65 MARQ. L. REV. 573 (1982); Michael L. Johnson, *The Crummey Trust After the Economic Recovery Act of 1981*, 9 OHIO N. UNIV. L. REV. 225 (1982); Malcolm A. Moore, *Tax Consequences and Uses of "Crummey" Withdrawal Powers: An Update*, 1988 INST. ON EST. PLAN. 11-1; Dora Arash, Note, *Crummey Trusts: An Exploitation of the Annual Exclusion*, 21 PEPP. L. REV. 83 (1993); Willard H. Pedrick, *Crummey Is Really Crummy*, 20 ARIZ. ST. L.J. 943 (1988); Charles F. Newlin, *Exclusions Expanded: New User for 'Crummey' Trust Contemplated*, 12 TR. & EST. 59 (1981); Charlotte M. Wilson, Note, *The Crummey Power and Inter Vivos Trusts: An Analysis of Estate, Gift, and Income Tax Consequences to the Trust Beneficiary*, 22 MEMPHIS ST. L. REV. 297 (1992).

but one in which the donee is not entitled to mandatory payments of income. Demand rights are often called "*Crummey* powers," referring to the name of the case in which they were approved.[303] A *Crummey* power is simply a general power of appointment created by the donor in another person.[304] The power entitles the donee to demand a specific portion of the trust corpus.[305] The donee is usually given a specific period in which to make the demand. Once this period expires, the donee has no right to such property.[306]

Crummey powers are treated as present interests and thus qualify for the annual exclusion as long as the donee is aware of the demand right and is given a realistic and meaningful period in which to exercise such right.[307] A right to demand property is, in effect, treated as the equivalent to possession of such property.[308] The mere fact that the trustee is not required to distribute the property until there has been a demand by the beneficiary does not preclude classification of the interest as a present interest.[309]

In *Crummey v. Commissioner*,[310] the Ninth Circuit approved the exclusion for demand provisions. In that case, the demand clause provided that whenever the donor made an addition to the trust, each minor beneficiary, or his or her guardian, could demand a distribution of the amount added to the trust or $4000, whichever was less.[311] The Ninth Circuit held that the demand right was a present interest, even though no guardians had been appointed nor were any likely to be appointed.[312] Consequently, the donor was entitled to an exclusion for each donee whenever amounts were added to the trust.[313]

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303. Crummey v. Commissioner, 397 F.2d 82 (9th Cir. 1968).
304. PEAT & WILLBANKS, *supra* note 65, at 82.
305. *See, e.g.*, Rev. Rul. 80-261, 1980-2 C.B. 279.
306. *See generally* CAMPFIELD ET AL., *supra* note 148, at 150.
307. Rev. Rul. 81-7, 1981-1 C.B. 474 (two-day period in which to exercise right was insufficient). *But see* Rev. Rul. 83-108, 1983-2 C.R.B. 167, 14 (if a trust beneficiary is granted a withdrawal power, it is a present interest eligible for the annual exclusion in the year of the transfer even though the beneficiary is not informed of the existence of the power until the following calendar year). *See also* Moore, *supra* note 302, at 11-9.
308. One of the risks of the *Crummey* power is that the donee will exercise his or her withdrawal rights. This, of course, defeats the purpose of a *Crummey* trust.
309. RASCH, *supra* note 192, at 336.
310. 397 F.2d 82.
311. *Id.* at 83.
312. *Id.* at 87-88.
313. For example:

> Mother, married, creates an irrevocable trust for the benefit of her four children. By gift splitting, and granting each beneficiary the right to withdraw a proportionate part of the funds transferred to the trust, she

But even the *Crummey* court noted that a demand provision is nothing more than a gimmick to secure the annual exclusion:

> Although under our interpretation neither the trust nor the law technically forbid a demand by the minor, the practical difficulties of a child going through the procedures seem substantial. In addition, the surrounding facts indicate the children were well cared for and the obvious intention of the trustors was to create a long term trust. No guardian had been appointed and, except for the tax difficulties, probably never would be appointed. As a practical matter, it is likely that some, if not all, of the beneficiaries did not even know that they had any right to demand funds from the trust. They probably did not know when contributions were made to the trust or in what amounts. Even had they known, the substantial contributions were made toward the end of the year so that the time to make a demand was severely limited. Nobody had made a demand under the provision, and no distributions had been made. We think it is unlikely that any demand ever would have been made.[314]

The *Crummey* court, nevertheless, allowed the donor to claim the annual exclusion for each donee who had a demand right.[315]

The holder of the demand provision is usually an income beneficiary of the trust, but this is not always the case:

> once the *Crummey* withdrawal right became established, it occurred to planners that the number of donees holding such rights, and therefore the number of $10,000 exclusions allowed, could be expanded indefinitely by giving such rights to numerous contingent beneficiaries. Although the donor did not expect any of the contingent beneficiaries to exercise the withdrawal right, and although the interests of the beneficiaries in the trust might be quite remote, it appeared that each beneficiary's withdrawal right could qualify for a $10,000 exclusion.[316]

This issue was first addressed by the I.R.S. National Office in 1987.[317] In that case, the donor created a trust under which his son was given a life estate and a general power of appointment. The son's wife and six descendants were to take the property by default if the son failed to exercise the general power of appointment, but otherwise had no other interest in the trust. The donor granted *Crummey* powers to his son, his son's wife, and each of the descendants. The donor consequently claimed eight annual

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> may transfer as much as $80,000 each year gift tax free under the annual exclusion.

Harris & Jacobson, *supra* note 155, at 206.

314. *Crummey*, 397 F.2d at 87.

315. The use of a *Crummey* power in a trust makes the most sense where the donor intends to make annual additions to the trust. In such cases, the donor obtains an annual exclusion for each contribution, not simply one exclusion at the time the trust is established. PEAT & WILLBANKS, *supra* note 65, at 86.

316. CAMPFIELD ET AL., *supra* note 148, at 150-51.

317. IRS Tech. Advice Memo. 8727003 (Mar. 16, 1987).

exclusions. The I.R.S. National Office denied the exclusion for the withdrawal rights held by the wife and the descendants on the basis that they had only "remote contingent interests" in the trust. According to the I.R.S.. National Office, the annual exclusion is allowed only for those donees having a continuing interest in the trust.

Five years later, the Tax Court confronted a similar case. In *Estate of Cristofani v. Commissioner*,[318] the donor created a trust under which her two children were the sole income beneficiaries. The two children and five minor grandchildren were given demand rights.[319] In addition to the demand rights, the five grandchildren were named as contingent beneficiaries of the trust, but there was little likelihood that their contingent remainders would ever vest in possession.[320] Based on these facts, the donor claimed seven annual exclusions.[321]

The I.R.S. allowed the annual exclusion for the children's demand rights, but denied the exclusion for the grandchildren's demand powers.[322] The Tax Court, however, allowed the exclusion for all of the demand powers, concluding:

> As discussed in *Crummey*, the likelihood that the beneficiary will actually receive present enjoyment of the property is not the test for determining whether a present interest was received. Rather, we must examine the ability of the beneficiary, in a legal sense, to exercise their right to withdraw trust corpus, and the trustee's right to legally resist a beneficiary's demand for payment. Based upon the language of the trust instrument and the stipulations of the parties, we believe that each grandchild possessed the legal right to withdraw trust corpus and that the trustees would be unable to legally resist a grandchild's withdrawal demand.[323]

The potential for abuse from this type of transfer is obvious. A donor can claim as many annual exclusions as people he or she can name in a trust instrument.[324] As a consequence, there is no true limit on the amount of money a person can transfer to his or her children free of tax.

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318. 97 T.C. 74 (1991).
319. *Id.* at 74-75.
320. *Id.*
321. *Id.* at 77.
322. *Id.* at 77-78.
323. *Id.* at 83 (citations omitted). The Commissioner has acquiesced in *Cristofani*, but only in result. *See* Rev. Rul. 1992-1 C.B. 1. *See also* Owen G. Fiore & John F. Ramsbacher, *Crummey Powers for Contingent Beneficiaries OK'd*, 19 INST. ON EST. PLAN. 10 (1992).
324. *See generally* Nicholas A. J. Vlietstra, Note, *Estate of Cristofani v. Commissioner: The Expanded Potential of Crummey Powers for Transfer Tax Avoidance*, 45 TAX LAW. 583 (1992).

The *Crummey* power is "hardly ever used for valid purposes and could be used to substantially evade the gift tax."[325] It has created a system in which the taxation of a particular transaction depends "not on the substance of the transaction but on its form."[326] "*Crummey* Trusts undermine the underlying policies of the annual exclusion by permitting it to be used as a vehicle for estate tax avoidance."[327] Such practice is contrary not only to the legislative history of the annual exclusion, but is inconsistent with the international standards of gift taxation. This Article proposes legislation designed to end such abuse.

Note that there is a potential danger in using *Crummey* withdrawal rights.[328] If the donee is given the power to demand more than $5000 per year, the donee may suffer gift tax consequences.[329] The withdrawal right is considered a general power of appointment. Like any general power of appointment, if the donee fails to exercise a withdrawal right, he is deemed to have made a transfer to the beneficiaries of the trust (other than himself)[330] in the amount that was subject to the withdrawal right.[331] This occurs because the failure to exercise a general power of appointment is considered a lapse of the power.[332] The I.R.C., however, provides a partial safe-harbor for such lapses. According to Section 2514(e), a lapse is considered a taxable transfer only if the amount as to which the lapse occurs exceeds the greater of $5000 or five percent of the amount subject to the power.[333] For example:

> If a *Crummey* transfer of $10,000 is made and the assets of the trust do not exceed $100,000, the result is that the "5,000 or 5 percent" rule of Section 2514(e) will apply only to the first $5,000 subject to the withdrawal right. Lapse of the withdrawal right as to

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325. Mason, *supra* note 302, at 607.
326. Pedrick, *supra* note 302, at 943.
327. Arash, *supra* note 302, at 125.
328. *See generally* William S. Huff, *The "Five and Five" Powers and the Lapsed Powers of Withdrawal*, 15 INST. ON EST. PLAN. 7-1 (1981); James N. Zartman & Barbra Goering, *New Planning Needed for Gifts in Trust Due to Increased Annual Exclusion*, 11 TAX'N FOR LAW. 4 (1982); William Natbony, *The Crummey Trust and "Five and Five" Powers After ERTA*, 60 TAXES 497 (1982).
329. CAMPFIELD ET AL., *supra* note 148, at 156.
330. *See* Harris & Jacobson, *supra* note 155, at 207 (If the holder of the withdrawal power is the only beneficiary of the trust, there are no potential gift tax consequences for the donee because "a gift cannot be made to one's self and since any lapsed general power of appointment lapses only in favor of the beneficiary or his estate, the lapse of the withdrawal power does not constitute a taxable gift.").
331. *Id.*
332. I.R.C. § 2514(e).
333. CAMPFIELD ET AL., *supra* note 148, at 156; Gissel, *supra* note 162, at 177-78.

> the second $5,000 will constitute a taxable gift. Because it will be a gift in trust, it will in many cases not qualify as a present interest gift and thus will not benefit from the annual per-donee exclusion.[334]

As a result, most *Crummey* powers are limited to the least of: (1) the donee's pro rata share of the transferred amount; (2) the annual exclusion of the transferor; or (3) $5000 or five percent of the trust corpus.[335] Otherwise, the donee faces adverse gift tax consequences.[336]

c. Section 2503(c)

In an effort to bring some certainty to the gift tax laws, Congress enacted Section 2503(c) in 1954.[337] Section 2503(c) originated in response to Congress' dissatisfaction with some earlier cases indicating that it might not be possible to make a gift for the benefit of a minor without violating the future interest rule.[338] By enacting Section 2503(c), Congress declared that if the grantor made a gift to a minor under certain prescribed circumstances, the donor would be assured of the annual exclusion.[339] Section 2503(c) provides a method by which a gift to a minor may qualify for the annual exclusion, despite the fact that the gift is not outright and does not require immediate expenditure for the benefit of the minor.[340] If the requirements of Section 2503(c) are met, not

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334. *Id.* As another example,

> Father (married), creates a single trust for the benefit of his four children each of whom has the power to withdraw (for 30 days after transfer) an amount equal to the lesser of their pro rata share (1/4) of any transfer, or $20,000 (the amount subject to the annual exclusion with gift splitting). In 1991, Father transfers $80,000 to the trust and all of the beneficiaries allow their withdrawal right to lapse. Each beneficiary is treated as having made a taxable gift of $15,000 to the other beneficiaries ($20,000 total lapse *less* $5,000 [the amount permitted under section 2514(e)]).

Harris & Jacobson, *supra* note 155, at 206.

335. STEPHENS ET AL., *supra* note 55, at 9-25; PEAT & WILLBANKS, *supra* note 65, at 85.

336. If the *Crummey* power permits the donee to demand more than $5000, the donee may be forced to file a gift tax return and use a portion of his or her unified credit. This problem is exacerbated because all of the donee's withdrawal rights are aggregated for purposes of the "$5000 or 5% rule." CAMPFIELD ET AL., *supra* note 148, at 156.

337. S. REP. NO. 83-1622, at 127 (1954); HARRIS, *supra* note 249, at 662-63 ("Prior to the 1954 Code there was much litigation on the question of whether particular gifts for the benefit of a minor constituted present interests or future interests.").

338. PLANNING LARGE ESTATES 404 (Selma Arnold ed., 1970).

339. *Id.*

340. STEPHENS ET AL., *supra* note 55, at 9-27.

just the income interest, but the entire corpus qualifies for the annual exclusion.[341] Similar to *Crummey* powers, Section 2503(c) creates a loophole in the gift tax system contrary to the purposes of the annual exclusion.[342]

According to Section 2503(c), no part of a transfer for the benefit of a minor will be considered a future interest (which would not qualify for the annual exclusion) if the terms of the transfer meet the following conditions: (1) both the property and its income may be expended by, or for the benefit of, the minor donee prior to his attaining the age of twenty-one,[343] and to the extent not so expended will pass to the donee at that time; and (2) in the event of the donee's death prior to reaching twenty-one years of age, the property and income not expended will pass to the donee's estate or to persons appointed by him under the exercise of a general power of appointment.[344]

As to the first element, the expenditures are not mandatory.[345] Rather, Section 2503(c) contemplates that the trustee or guardian may exercise his or her discretion regarding expenditures of income or corpus for the benefit of the minor donee.[346] To qualify for Section 2503(c) treatment, however, there must be no substantial restrictions on the exercise of such discretion.[347] Amounts expendable, for example, for the minor's "support, care, education, comfort and welfare"[348] or for the "support or maintenance which the [s]ettlors . . . are legally obligated to provide"[349] or as the trustee "deems necessary for [the] child's support, health and education"[350] are not considered substantial restrictions and, consequently, such trusts qualify for the annual exclusion. By contrast, if the expenditures are limited to those arising out of

341. *Id.*

342. CAMPFIELD ET AL., *supra* note 148, at 156-57 (the *Crummey* trust permits greater flexibility than either § 2503(c) or the Uniform Gifts to Minors Act).

343. The I.R.S. has ruled that the annual exclusion is available in those states that have lowered the age of majority to 18. Rev. Rul. 73-287, 1973-2 C.B. 321.

344. I.R.C. § 2503(c) (1996). If the minor is given a general power of appointment, this element is satisfied even if (1) the power is exercisable either during lifetime or by will or (2) under local law the minor can neither exercise a power of appointment nor execute a valid will. Treas. Reg. § 25.2503-4(b) (1996). Unless the drafter of the trust has a good reason for doing otherwise, he or she should follow the language of § 2503(c) precisely. PLANNING LARGE ESTATES, *supra* note 338, at 410.

345. *See generally* Adams, *supra* note 13, at 126-27.

346. STEPHENS ET AL., *supra* note 55, at 9-28.

347. Treas. Reg. § 25.2503-4(b)(1) (1996).

348. Rev. Rul. 67-270, 1967-2 C.B. 349.

349. Upjohn v. United States, 72-2 U.S. Tax Cas. (CCH) P12,888.

350. Mueller v. United States, 69-1 U.S. Tax Cas. (CCH) P12, 592.

"accident, illness or other emergency"[351] or "illness, infirmity or disability,"[352] such limits impose substantial restrictions on the trustee and, as such, the trusts fail to qualify for the annual exclusion.[353]

As to the second requirement, the trust instrument may provide for the extension of the trust at the election of the donee upon his attaining age twenty-one.[354] The trust instrument may even require the donee to perform an affirmative act within a limited period of time to compel distribution of the property.[355] For instance, the annual exclusion is available where the minor beneficiary has, upon reaching age twenty-one, either:

> (1) a continuing right to compel immediate distribution of the trust corpus by giving written notice to the trustee, or to permit the trust to continue by its own terms, or (2) a right during a limited period to compel immediate distribution of the trust corpus by giving written notice to the trustee—a right which, if not exercised, will permit the trust to continue by its own terms.[356]

As one author explained:

> For those donors who want the gift tax annual exclusion . . . afforded by a Section 2503(c) trust but are loath to have the trust property distributed to a 21-year-old beneficiary, the extension of the trust beyond age 21 can be a good solution. As with the *Crummey* power, the beneficiary's right of withdrawal is limited—there is only a 'window of opportunity' to make the withdrawal.[357]

It is possible for a gift of an income interest to a minor to qualify for the annual exclusion even though the gift of the corpus does not.[358] This can occur because each interest transferred is treated separately to determine whether it satisfies the requirements of Section 2503(c).[359] The exclusion will be allowed for an income interest if:

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351. Faber v. United States, 439 F.2d 1189, 1190 (6th Cir. 1971).

352. Pettus v. Commissioner, 54 T.C. 112, 121 (1970).

353. It is not a substantial restriction to require the trustee to deal with the trust property as though he were the guardian of the minor's person and estate. *See* Ross v. United States, 348 F.2d 577 (5th Cir. 1965).

354. Treas. Reg. § 25.2503-4(b)(2) (1996).

355. Rev. Rul. 74-43, 1974-1 C.B. 285.

356. FEDERAL ESTATE AND GIFT TAXES EXPLAINED, *supra* note 64, at 400.

357. Spencer, *supra* note 124, at 265. Section 2503(c) trusts are uniquely suited for gifts of life insurance. The policy value and the annual premium are almost certain to be within the annual exclusion. As a result, the policy may be transferred to the trust without incurring gift taxation.

358. *See generally* Herr v. Commissioner, 35 T.C. 732 (1961), *aff'd*, 303 F.2d 780 (3d Cir. 1962); Weller v. Commissioner, 38 T.C. 790 (1962); Konner v. Commissioner, 35 T.C. 727 (1961); Estate of Levine v. Commissioner, 526 F.2d 717 (2d Cir. 1975).

359. *See generally* Ronald J. Restrepo, Note, *Recent Development–Gift Tax*, 64 GEO. L.J. 131 (1975). A trust instrument that does not satisfy the

> (1) the income may be used for the beneficiary's benefit during minority; (2) the accumulated income will be distributed to him or her at age 21; and (3) the accumulated income is payable to the beneficiary's estate, or to persons designated in his will, if he dies before reaching 21.[360]

If, however, the trustee has the power to allocate income and expenses between the corpus and income interests, the annual exclusion for the income interest may be denied.[361]

d. Uniform Gifts to Minors Act

All states have adopted laws facilitating the making of gifts to minors.[362] In many states, these laws conform to the Uniform Gifts to Minors Act (hereinafter UGMA), the Uniform Gifts of Securities to Minors Act, or the Uniform Transfers to Minors Act (hereinafter UTMA).[363] Before the enactment of these acts, donors were often compelled to transfer property to the beneficiary's legal guardian.[364] "Guardianships, however, present their own set of problems. A guardian must obtain court approval for every transaction, and the guardian's investment powers may be severely restricted."[365] The UGMA and UTMA were enacted to alleviate some of these problems.[366]

Under these uniform acts, a gift may be made to a minor through a custodian, thereby eliminating the need for appointing a guardian or establishing a formal trust.[367] Transfers under these acts are simple to make. Moreover, these acts grant the custodian broad powers to deal with the property without court supervision and allow investment decisions to be governed by the prudent

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requirements of § 2503(c) may not be amended retroactively to obtain the annual exclusion. HOLZMAN, *supra* note 47, at 57; Rollman v. United States, 342 F.2d 62 (Ct. Cl. 1965).

360. FEDERAL ESTATE AND GIFT TAXES EXPLAINED, *supra* note 64, at 399. A power of appointment satisfies § 2503(c) even though takers in default are designated by the donor. Treas. Reg. § 25.2503-4(b)(3) (1996).

361. FEDERAL ESTATE AND GIFT TAXES EXPLAINED, *supra* note 64, at 399-400.

362. GERHART, *supra* note 18, at 23. This includes the District of Columbia.

363. *See, e.g.*, Dominick J. Delorio, *Uniform Gifts to Minors Act*, 112 MIL. L. REV. 159 (1986); Burke A. Christensen, *Policies on Children May be the Ultimate Appreciating Asset*, 131 TR. & EST. 61 (1992); PLANNING LARGE ESTATES, *supra* note 338, at 413-16.

364. *See generally* Thomas E. Atkinson, *Symposium on Guardianship*, 45 IOWA L. REV. 209, 210-11 (1960) ("the principal problems of property guardianship have not been losses due to dishonesty or incompetence of the fiduciary but rather to the red tape and expense of the court supervised administration").

365. PEAT & WILLBANKS, *supra* note 65, at 87-88.

366. Departures from the model acts may disqualify the gifts. *See* Bittker, *supra* note 17, at 471.

367. *See* HOLZMAN, *supra* note 47, at 60.

investor rule.[368] The custodian can be the donor, another adult individual, or a bank or similar institution.[369]

The I.R.S. has ruled that gifts made under the UGMA or UTMA qualify for the annual exclusion.[370] The exclusion is:

> warranted under IRC Section 2503(c) because the custodian has the requisite authority to use the property and income for the minor's benefit until age 21, as required by IRC section 2503(c)(1), and must distribute any unexpended amount to the donee at age 21 or to the donee's estate in the event of prior death, as required by IRC section 2503(c)(2).[371]

Like Section 2503(c), however, gifts made under the custodianship acts contravene the purpose of the annual exclusion. The exclusion was designed to exempt occasional gifts from taxation and not as a vehicle to transfer large amounts of money from generation to generation.

When one examines the way the courts and the I.R.S. have applied the annual exclusion to various types of transfers, the need for reform becomes obvious. The annual exclusion has evolved into one of the most abused and complex provisions in the I.R.C. The practice of preferring form over substance must end. The reform proposal set forth in this Article will simplify the gift tax laws and thereby end annual exclusion abuse.

IV. THE OTHER GIFT TAX EXCLUSIONS, DEDUCTIONS, AND CREDITS

To fully comprehend the significance of the annual exclusion, one must be cognizant of the litany of exclusions, deductions, and credits in the gift tax system. With all of the gift tax exemptions available to taxpayers, no one should be paying estate and gift tax in this country. In other words, when the tax-avoidance potential of the annual exclusion is combined with the other gift tax exclusions, deductions, and credits, anyone wishing to evade transfer taxes can do so quite easily and quite legally.[372]

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368. PEAT & WILLBANKS, *supra* note 65, at 87.

369. Bittker, *supra* note 17, at 470-71. It should be noted that if the donor names himself as custodian of the property and dies before the donee reaches age 21, the transferred property will be included in the donor's gross estate for estate tax purposes. Stuit v. Commissioner, 54 T.C. 580 (1970), *aff'd*, 452 F.2d 190 (7th Cir. 1971).

370. Rev. Rul. 59-357, 1959-2 C.B. 212. Transfer under the UGMA is a complete gift at the time of transfer to the extent of the full fair market value of the transferred property. Rev. Rul. 56-86, 1956-1 C.B. 449.

371. Bittker, *supra* note 17, at 471.

372. Note that there are penalties for underpayment of gift tax. The penalties ranges from 20% to 40% of the understated tax. RAPKIN, *supra* note 17, at 5-22.

A. *Section 2503(e)*

Under Section 2503(e), a taxpayer may pay someone's unreimbursed medical expenses or academic tuition without incurring gift taxation.[373] Prior to the enactment of Section 2503(e), such payments were considered taxable gifts, unless made to discharge the transferor's legal support obligations.[374] Section 2503(e) exempts such payments from taxation, regardless of a legal support obligation.[375] Indeed, such payments are not limited to the donor's children or even to the donor's dependents.[376] The exclusion applies to payments made on behalf of any individual. More importantly, these transfers escape the gift tax without consuming any part of the donor's annual exclusion or unified credit.[377] Consequently, a taxpayer may give each of his children $10,000 per year and pay their unreimbursed medical expenses and college tuition without incurring gift tax.[378]

The term "unreimbursed medical expenses" is defined in Section 213(d) and includes expenditures for the diagnosis, treatment, and prevention of illness, as well as medical insurance premiums.[379] No exclusion is permitted for medical expenses that

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373. I.R.C. § 2503(e) (1996). In 1969, the American Law Institute's Estate and Gift Tax Project proposed enactment of a provision exempting transfers made for consumption purposes from the gift tax. Under this proposal, expenditures would not constitute taxable gifts if made for:

> (a) the benefit of any person residing in the transferor's household, or for the benefit of a child of the transferor under 21 years of age, whether or not he resides in the transferor's household, provided that such expenditure does not result in such person or child acquiring property which will retain significant value after the passage of one year from the date of such expenditure; or
>
> (b) current educational, medical or dental costs of any person; or
>
> (c) current costs of food, clothing and maintenance of living accommodations of any person in fact dependent on the transferor, in whole or in part, for support, provided such expenditure is reasonable in amount.

374. STEPHENS ET AL., *supra* note 55, at 9-32; PRICE, *supra* note 24, at 107.

375. Section 2503(e) was not intended to change the law that no gift is made if the donor is obligated to provide such items under local law. *See, e.g.*, Gissel, *supra* note 162, at 169.

376. Bryson L. Cook, *Lifetime Giving*, *in* EXPLORING THE IMPACT OF THE ECONOMIC RECOVERY TAX ACT ON ESTATE PLANNING 19 (1982) (relationship between the donor and donee is irrelevant).

377. *See, e.g.*, CAMPFIELD ET AL., *supra* note 148, at 165 ("The exclusion is unlimited in amount and is available over and above the $10,000 annual per donee exclusion under Section 2503(b)."). If only part of the transfer is covered by § 2503(e), the remainder may be covered by the annual exclusion. RASCH, *supra* note 192, at 350.

378. *See generally* Gutman, *supra* note 8, at 1241.

379. BITTKER & CLARK, *supra* note 98, at 74.

are reimbursed by insurance or other means.[380] Payments must be made directly to the health care provider to qualify for the exclusion. Medical expenses paid directly to a donee do not qualify under Section 2503(e).[381]

Section 2503(e) also excludes from gift tax any amount paid of behalf of an individual to an educational institution.[382] The term "educational institution" is defined in Section 170(b) and includes most colleges and universities.[383] In order to qualify for the exclusion, payments must be made directly to the educational institution.[384] Unless otherwise exempt, payments made directly to a donee as reimbursement for tuition expenses incurred by the donee are taxable gifts.[385] The exclusion is limited to tuition payments. Payments for lodging, board and books are not exempted by Section 2503(e).[386] Such ancillary payments are not taxable gifts, however, if encompassed within the donor's legal support obligation.[387]

B. *Gift Tax Deductions*

The gift tax is imposed upon the net or "taxable gifts" made by the taxpayer during the calendar year.[388] After the taxpayer's gross gifts are determined by subtracting the gift tax exclusions from the total gifts, his "taxable gifts" are ascertained by subtracting from the gross gifts any deductions to which he or she is entitled.[389]

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380. SURREY ET AL., *supra* note 182, at 685. This rule applies whether reimbursement is paid in the same tax year as the donor's payment or in a later year. RASCH, *supra* note 192, at 351.

381. SURREY ET AL., *supra* note 182, at 685. *See also* Gissell, *supra* note 162, at 169.

382. I.R.C. § 2503(e) (1996).

383. *See generally* David Williams, II, *Financing a College Education: A Taxing Dilemma*, 50 OHIO ST. L.J. 561, 585 (1989). A "qualifying educational organization" is defined as an institution "which normally maintains a regular faculty and curriculum, and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on." I.R.C. § 170(b)(1)(A)(ii).

384. Treas. Reg. § 25.2503-6(b)(2) (1996). The exclusion is available for payments on behalf of both part-time and full-time students. RASCH, *supra* note 192, at 352.

385. Leimberg, *supra* note 12, at 8.16; RABKIN & JOHNSON, *supra* note 158, at 51-68 (there is no exclusion for an amount set up in a trust to provide for a child's education).

386. SURREY ET AL., *supra* note 182, at 685; Gissel, *supra* note 162, at 168.

387. SURREY ET AL., *supra* note 182, at 685.

388. LOWNDES ET AL., *supra* note 73, at 647.

389. *Id. See also* DUBROFF & KAHN, *supra* note 4, at 10; PAUL, *supra* note 32, at 967-68.

The gift tax has two principal deductions. The most important deduction from gift taxation is the marital deduction.[390] Since 1948, the gift tax has recognized a deduction for gifts between spouses.[391] Initially, the purpose of the deduction was to equalize the impact of federal gift tax upon married taxpayers in community property and separate property states.[392] As such, the deduction was limited to one-half of the property that one spouse transferred to another.[393] Today, however, subject to certain limitations, inter-spousal transfers are entirely tax-free, or fully deductible.[394] There are, therefore, no limits on the amount of the marital deduction.[395]

One major exception to the marital deduction exists, however;[396] a deduction is not allowed if the spouse receives a terminable interest in the transferred property, such as a life estate or an income interest in a trust.[397] This rule precludes a marital deduction unless the spouse receives an interest in property that will constitute a gift by him or her if given away during his or her lifetime, or will be included in his or her gross estate if retained until death.[398] In other words, an inter-spousal transfer cannot be used to shield a subsequent third-party transfer from estate and gift taxation.[399] The terminable interest rule is exceedingly technical and has several exceptions and qualifications, all of which are beyond the scope of this Article.[400]

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390. I.R.C. § 2523. *See* CAMPFIELD ET AL., *supra* note 148, at 166-68; Gissel, *supra* note 162, at 173.

391. LOWNDES ET AL., *supra* note 73, at 648; SUTKOWSKI & KUPPLER, *supra* note 60, at 9.

392. LOWNDES ET AL., *supra* note 73, at 648.

393. *Id.* *See also* BOWE, *supra* note 22, at 31-33; Robert H. Montgomery, FEDERAL TAXES—ESTATES, TRUSTS AND GIFTS 32-35 (1950-51).

394. STEPHENS ET AL., *supra* note 55, at 11-19. The gift-splitting provision does not apply to gifts of community property, as such gifts are automatically treated as being made one-half by each spouse. There is, consequently, no need for gift-splitting. *See* FEDERAL ESTATE AND GIFT TAXES EXPLAINED, *supra* note 64, at 393.

395. Cook, *supra* note 376, at 14. On a related point, the payment of income taxes due on a joint return by one spouse is not a taxable gift. The same rule applies to the payment by one spouse of joint gift tax liability, which often occurs in gift-splitting cases. *See* FEDERAL ESTATE AND GIFT TAXES EXPLAINED, *supra* note 64, at 381. The marital deduction is limited to gifts made to citizens of the United States. However, an annual exclusion of $100,000 is allowed for gifts made to a spouse who is not a citizen of the United States. I.R.C. § 2523(i)(2) (1996).

396. *See generally* Joseph Isenbergh, *Simplifying Retained Life Interests, Revocable Transfers, and the Marital Deduction*, 51 U. CHI. L. REV. 1, 19-33 (1984).

397. I.R.C. § 2523.

398. STEPHENS ET AL., *supra* note 55, 11-11.

399. *Id.*

400. *See generally* I.R.C. §§ 2523 & 2056. There is a major exception to the terminable interest rule for "qualified terminable interest property," otherwise known as "QTIP." Under the QTIP rules, a life interest granted to a spouse will

The other important gift tax deduction is the charitable deduction.[401] The charitable deduction is measured by the amount of money given, or the fair market value of property given, to a qualified charitable organization.[402] Qualified recipients include governmental entities, traditional charities, fraternal societies, and veterans' groups.[403] "[D]irect gratuities to poor or otherwise worthy individuals, no matter how much they may be inspired by charitable impulses, give rise to no deduction. To be deductible, gifts must be made to qualified recipient organizations."[404]

There are no percentage or dollar limits on the gift tax charitable deduction, unlike its income tax counterpart.[405] In other words, a taxpayer can transfer all of his or her assets to a qualified charity without incurring any gift taxation. The only significant limit on the charitable deduction involves split-interest gifts.[406] Split-interest gifts are those in which both a qualified

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not be treated as a terminable interest and the entire value of the property in which the spouse is granted an interest will qualify for the marital deduction. If the spouse transfers the QTIP property during his or her lifetime, the spouse is deemed to have made a transfer of the property for gift tax purposes. If the property is not transferred during the spouse's lifetime, the entire value of the QTIP property is included in the spouse's gross estate upon his or her death. *See* FEDERAL ESTATE AND GIFT TAXES EXPLAINED, *supra* note 64, at 405-06.

401. I.R.C. § 2522; HARRIS, *supra* note 249, at 670-74.

402. STEPHENS ET AL., *supra* note 55, at 11-2 & 11-3.

403. I.R.C. § 2522(a). More specifically, the four categories of qualified recipients are:

> 1. The United States, any state, or any political subdivision thereof, or the District of Columbia, for exclusively public purposes.
>
> 2. Any corporation, trust, community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), including the encouragement of art and the prevention of cruelty to children or animals. No part of the net earnings of such organization may inure to the benefit of any private shareholder or individual. Furthermore, it may not attempt to influence legislation or participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office).
>
> 3. A fraternal society, order, or association, operating under the lodge system, provided such gifts are to be used by such fraternal society, order, or association exclusively for one or more of the purposes enumerated in (2), above.
>
> 4. Any organization of war veterans or auxiliary unit or society thereof if such organization, auxiliary unit, or society thereof is organized in the United States or any of its possessions. No part of its net earnings may inure to the benefit an any private shareholder or individual.

404. STEPHENS ET AL., *supra* note 55, at 11-3.

405. *See* I.R.C. § 170.

406. A special rule is provided for split-interest gifts in which the property is transferred to the donor's spouse and a qualified charity. If the donor creates a qualified charitable remainder annuity or unitrust and if the donor and his or her

charitable recipient and a non-qualified individual receive interests in the same property.[407] Generally, no deduction is allowed for split-interest gifts, but there are several statutory exceptions to this rule.[408]

C. *Miscellaneous Exclusions*

A loan of property without any charge is a transfer of an interest in property subject to gift taxation. If such a loan is made to a charity, the transfer will not qualify for a charitable deduction because of the split-interest rule.[409] Section 2503(g) partially alleviates this problem by treating some charitable loans as tax-free gifts.[410] Under Section 2503(g),[411] a loan of an archaeological, historic, or creative work of art to either a public charity or a private operating foundation is considered a non-transfer for gift

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spouse are the only noncharitable beneficiaries, the prohibition on deduction of terminable interests does not apply. The charitable and marital deductions, combined, exempt the entire amount of such gifts from taxation. I.R.C. § 2523(g).

407. I.R.C. § 2522(c).

408. *See generally* I.R.C. § 2522. The allowance of gift tax deductions for split-interest gifts is limited to remainder interests in annuity trusts and unitrusts, to remainder interests in pooled income funds, to other interests that are payable in the form of a guaranteed annuity or a fixed percentage distributed yearly of the fair market value of property, to remainder interests in nontrust transfers of residences and farms, and to nontrust transfers of an undivided portion of a donor's entire interest in property. FEDERAL ESTATE AND GIFT TAXES EXPLAINED, *supra* note 64, at 403-04. These narrowly-tailored exceptions are designed to ensure that the charity will in fact receive value equivalent to the deduction provided for the donor. CAMPFIELD ET AL., *supra* note 148, at 168.

409. STEPHENS ET AL., *supra* note 55, at 9-33.

410. I.R.C. § 2503(g). *See also* Cook, *supra* note 376, at 16-17.

411. I.R.C. § 2503(g) provides:

> (1) In General.-- For purposes of this subtitle, any loan of a qualified work of art shall not be treated as a transfer (and the value of such qualified work of art shall be determined as if such loan had not been made) if--
>
> (A) such loan is to an organization described in section 501(c)(3) and exempt from tax under section 501(c) (other than a private foundation), and
>
> (B) the use of such work by such organization is related to the purpose or function constituting the basis for its exemption under section 501.
>
> (2) Definitions.-- For purposes of this section--
>
> (A) Qualified Work of Art.-- The term "qualified work of art" means any archaeological, historic, or creative tangible personal property.
>
> (B) Private Foundation.-- The term "private foundation" has the meaning given such term by section 509, except that such term shall not include any private operating foundation (as defined in section 4942(j)(3)).

Id.

tax purposes, so long as the artwork is used by the charity in carrying out its charitable purpose or function.[412]

In addition, Section 2503(f) exempts from gift taxation a waiver of survivorship benefits, the right to future benefits under a qualified joint-and-survivor annuity, or a qualified preretirement survivorship annuity by a nonparticipant spouse, if the waiver occurs prior to the death of the participant spouse.[413]

Transfers of money or property to a qualified political organization are not subject to gift taxation.[414] A qualified political organization is a party, committee, association, fund, or other organization that is organized and operated primarily for the purpose of accepting contributions to influence the selection, nomination, election, or appointment of an individual to public office.[415]

D. *The Unified Credit*

Section 2505 provides a credit against a donor's gift tax liability.[416] This credit is known as the unified credit.[417] The unified credit may be used to offset $192,800 of gift tax liability.[418] It reduces the gift tax liability dollar for dollar.[419] The practical effect of the unified credit is to shelter the first $600,000 of "taxable gifts" from tax.[420] A married couple has two unified credits entitling them to transfer $1.2 million of "taxable gifts" to their children or grandchildren free of tax.[421] "The $192,800 is called a 'unified credit' because it is available only once to each taxpayer and applies to inter vivos [transfers] as well as to transfers at

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412. STEPHENS ET AL., *supra* note 55, at 9-33 & 9-34; Cook, *supra* note 376, at 16-17.

413. I.R.C. § 2503(f).

414. FEDERAL ESTATE AND GIFT TAXES EXPLAINED, *supra* note 64, at 379.

415. *Id.* at 379-80.

416. I.R.C. § 2505.

417. *See, e.g.*, DUBROFF & KAHN, *supra* note 4, at 342-346.

418. I.R.C. § 2001. Prior to 1977, the first $30,000 of lifetime gifts were exempt from gift taxation. The increase of the unified credit to $192,800 represented a historic turning point in the philosophy of federal estate and gift taxation. The increase resulted in a sharp reduction in the number of inter vivos transfers subject to gift tax. *See* CAMPFIELD ET AL., *supra* note 148, at 128.

419. The unified credit was gradually increased from $47,000 to $192,800 over six years from 1982 to 1987. *See* Cook, *supra* note 376, at 13. In order for an individual to maximize the economic benefit of the unified credit, he or she should use the unified credit during life as opposed to having the estate use the credit at death. Harrison, *supra* note 7, at 377.

420. CAMPFIELD ET AL., *supra* note 148, at 127.

421. Annual exclusion gifts are not included in "taxable gifts." MODERN ESTATE PLANNING 4-53 (1992).

death."[422] Any portion of the unified credit not used during life may be applied to offset a donor's estate tax liability.[423]

Use of the unified credit is mandatory.[424] In other words, a donor may not postpone the use of the unified credit to reduce future gift tax or estate tax liability.[425] Failure to use the credit, when available, will result in denial of the credit to the extent it was not used.[426] Congress chose to use a credit rather than a deduction since it "views credits as more equitable than deductions because they reduce tax liability equally for taxpayers in all brackets, while deductions confer greater tax savings on taxpayers in higher brackets."[427]

The unified credit applies only to "taxable gifts."[428] Gifts exempted from taxation by the annual exclusion or Section 2503(e) are not considered taxable gifts. Consequently, the $600,000 of gratuitous transfers exempted from taxation by the unified credit are in addition to those exempted by the annual exclusion.

The benefits of the unified credit are phased out beginning with cumulative transfers above ten million dollars.[429] "This is accomplished by adding five percent of the excess of any transfer over $10 million to the tentative tax computed in determining the ultimate transfer tax liability."[430] This "surtax" is levied on amounts transferred in excess of ten million dollars but not exceeding $21,040,000.[431] As such, the surtax recaptures the

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422. *Id.*

423. If the credit is fully used to shelter inter vivos transfers, the practical effect is to deprive the taxpayer's estate of any benefit from the credit. If the credit is partially used during lifetime, the practical effect is to make only the remaining portion available to the taxpayer's estate. If none of the credit is used during lifetime, the entirety of the credit will be available to the taxpayer's estate. CAMPFIELD ET AL., *supra* note 148, at 127.

424. Private Letter Ruling 7842068; RAPKIN, *supra* note 17, at 5-17.

425. Beck, *supra* note 121, at 9-4. On the other hand, there is no penalty for early use of the unified credit. In fact, the earlier it is used the more effective it is as an estate tax avoidance device. RAPKIN, *supra* note 17, at 5-17.

426. STEPHENS ET AL., *supra* note 55, at 9-45.

427. *Id.* at 9-43. *See also* CAMPFIELD ET AL., *supra* note 148:

> If Congress had granted a $600,000 deduction, the benefit of the deduction would have varied markedly depending on the size of the estate. For an estate of only $600,000, the saving in tax would be $192,800. But for an estate of $12,000,000, subjected to a marginal rate of 60%, the tax saving would be $360,000.

Id. at 128.

428. *See generally* RABKIN & JOHNSON, *supra* note 158, at 51-80.

429. FEDERAL ESTATE AND GIFT TAXES EXPLAINED, *supra* note 64, at 9.

430. *Id.*

431. *See generally* PRICE, *supra* note 24, at 98.

benefit of the unified credit, as well as any transfer tax rate below fifty-five percent.

The Taxpayer Relief Act of 1997 provided for a gradual increase in the unified credit to an amount sufficient to exempt $1 million of gratuitous transfers from estate and gift tax.[432] Congress also mandated that the unified credit be indexed for inflation.[433] Such proposals mean that a couple could transfer at least $2 million of "taxable gifts" to their descendants without incurring gift taxation. Obviously, such measures would exempt nearly all U.S. citizens from transfer tax.[434] If the United States is serious about transfer taxation, then such an increase is misguided. If it is not serious, then Congress should quit making piece-meal changes to the Internal Revenue Code and instead scrap the entire transfer tax system.

E. *Interest-Free Loans*

A loan is generally not considered a gratuitous transfer, as the borrower has a legal obligation to repay the loan with interest.[435] For years, however, interest-free loans were used to avoid gift taxation.[436] In fact, the courts had approved such use of interest-free loans, holding that loans did not diminish the taxpayer's estate because the borrower was obligated to repay the principal of the loan.[437] This position, however, was overruled in *Dickman v. Commissioner*.[438] In that case:

> the Supreme Court, taking a modern view of property as a bundle of rights, found that the right to use the property was not only a valuable and legally protectable property right, but perhaps the most significant right in the bundle. Where a taxpayer makes a transfer of such a right, as opposed to consuming or wasting the property or investing it in another enterprise, that transfer is subject to the gift tax.[439]

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432. Such a provision was enacted shortly before this Article went to press. *See* Taxpayer Relief Act of 1997, H.R. 2014.

433. *Id.*

434. In 1987, only 2.6% of the Americans dying that year had sufficient wealth to require the filing of transfer tax returns. *See generally* Bittker & Clark, *supra* note 98, at 7-8.

435. *See generally* MANNING, *supra* note 129, at 168-70.

436. *See* RAPKIN, *supra* note 17, at 5-10 ("Spurred on by a series of favorable court decisions, taxpayers utilized the interest-free loan as an estate planning tool, designed to shift future earnings, accumulations and appreciation to younger, less affluent generations.").

437. Crown v. Commissioner, 67 T.C. 1060 (1977), *aff'd*, 585 F.2d 234 (7th Cir. 1978).

438. 465 U.S. 330 (1984).

439. PEAT & WILLBANKS, *supra* note 65, at 47.

In the same year that the Supreme Court decided *Dickman*, Congress enacted Section 7872.[440] Although primarily concerned with the income tax consequences of interest-free loans, Section 7872 does have a gift tax component. Under that section, if a transferor makes an interest-free loan, the transferor is deemed to have made a gift to the borrower equal to the interest the transferor would have received had a market rate of interest been charged.[441]

A gift loan is any below-market loan in which the lender gratuitously forgoes interest. For gift tax purposes:

> The extent of a lender's federal gift tax liability on a below-market gift loan is dependent upon whether the loan is a demand or a term loan. If a demand loan is involved, the lender is deemed to have made a gift to the borrower on the last day of each year the loan is outstanding....
>
> .... In the case of a term loan, the lender is deemed to have made a cash gift to the borrower on the date the loan was made.[442]

Suffice it to say, Section 7872 has taken most of the tax benefits out of interest-free loans.[443]

There is, however, an exemption from gift taxation for certain interest-free loans. For gift tax purposes, no interest will be imputed to either the lender or the borrower for any day on which the aggregate outstanding balance between such individuals does not exceed $10,000.[444] However, if the loan balance exceeds $10,000 on any given date, Section 7872 will apply to the entire amount of the loan, not just the amount in excess of $10,000.[445] The $10,000 de minimus exception does not apply where the loan proceeds may be directly traced to the purchase of income-producing assets.[446]

In addition to the $10,000 de minimus exception for interest-free loans, a lender may use the annual exclusion to offset up to $10,000 of imputed interest per year to each donee.[447] In a period of low interest rates, this means that a donor could make interest-

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440. *See generally* Michael D. Hartigan, *From Dean and Crown to the Tax Reform Act of 1984: Taxation of Interest-Free Loans*, 60 NOTRE DAME L. REV. 31 (1984).

441. These same rules apply to the rent-free use of property. *See generally* PEAT & WILLBANKS, *supra* note 65, at 51.

442. FEDERAL ESTATE AND GIFT TAXES EXPLAINED, *supra* note 64, at 383.

443. Corneel & Graham, *supra* note 120, at 606.

444. *Id.* For purposes of the exception, a married couple is treated as one person. I.R.C. § 7872(f)(7).

445. FEDERAL ESTATE AND GIFT TAXES EXPLAINED, *supra* note 65, at 383-84.

446. *Id.* at 384. *See also* RAPKIN, *supra* note 17, at 5-48.

447. BITTKER & CLARK, *supra* note 98, at 62.

free loans in excess of $100,000 to as many donees as he or she pleases without incurring gift tax.[448]

F. *Generation-Skipping Tax*

In most cases, if a taxpayer transfers $10,000 to each of his or her grandchildren, such gifts will be exempted from gift taxation by the annual exclusion.[449] But will such gifts be subject to generation-skipping tax? The answer is no.[450] The generation-skipping tax (hereinafter GST) contains a number of exclusions and exemptions, three of which are relevant to this Article.[451]

First, a "direct skip" transfer, such as the one in the prior paragraph, is defined for GST purposes as a transfer that is subject to either gift tax or estate tax.[452] "Thus outright transfers that qualify for the gift tax annual exclusion and transfers that escape the gift tax because they are payments of medical or educational expenses escape the generation-skipping transfer tax as well."[453]

A second exclusion from GST occurs because Section 2612(c)(2) "excludes from the definition of a direct skip a transfer to a grandchild of the transferor if at the time of the transfer, the parent of the grandchild, *i.e.*, the transferor's child, is deceased."[454] In such cases, a gift from a grandparent is treated as if made by a parent, and thus is not subject to GST.

Not all transfers that qualify for the annual exclusion are exempt from GST.[455] In other words, some annual exclusion gifts made by a donor to his or her grandchildren will be subject to GST.[456] This does not mean, however, that a tax will be imposed. The third exemption from GST will shield most multigenerational transfers from GST. Section 2631 provides a flat one million dollar lifetime exemption from GST for every transferor.[457] A married

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448. *See generally* John R. Price, *Intrafamily Transfers: Blessed and More Blessed Ways to Give*, *in* INST. ON EST. PLAN. 6-1, 6-15 (1984).

449. I.R.C. § 2503(b).

450. *See generally* JEROLD I. HORN, PLANNING AND DRAFTING FOR THE GENERATION-SKIPPING TRANSFER TAX 89 (2d ed., 1994). ("Any transfer of property to the extent the transfer is excluded from the donor's taxable gifts by reason of an annual exclusion according to Code Section 2503(b), after application of gift-splitting according to Code Section 2513(a), is a 'nontaxable gift.' Certain nontaxable gifts are exempt from the generation-skipping tax.").

451. PRICE, *supra* note 24, at 131-64.

452. I.R.C. § 2612(c)(1).

453. PEAT & WILLBANKS, *supra* note 65, at 236. *See also* CAMPFIELD ET AL., *supra* note 148, at 130.

454. PEAT & WILLBANKS, *supra* note 65, at 237.

455. Some direct skips to a trust are subject to GST even if such transfers qualify for the annual exclusion. *Id.* at 326.

456. *Id.*

457. I.R.C. § 2631.

couple has two exemptions, entitling the couple to transfer two million dollar without incurring GST. A transferor can allocate the million dollar exemption in any manner he or she chooses.[458] The transferor is not required to allocate the exemption to the first GST transfers he or she makes, but may save the exemption for future GST liability.[459]

G. *Cumulative Effect of Gift Tax Exemptions*

The gift tax annual exclusion can be used by a taxpayer to transfer millions of dollars to his or her descendants free of estate tax, gift tax, and GST. For most taxpayers, the annual exclusion, by itself, is sufficient to evade all transfer taxes. However, when combined with the other exclusions, exemptions, deductions, and credits, the annual exclusion has indisputably converted the transfer tax system into a voluntary tax,[460] as illustrated by the following summary of tax-free transfers:

> (1) Subject to the future interest limitation, a taxpayer may transfer $10,000 each to as many people as he or she pleases and may repeat such transfers year after year.[461] A married couple can double this amount.[462]
>
> (2) With certain exceptions, a taxpayer may transfer an unlimited amount of property to his or her spouse.[463]
>
> (3) With certain exceptions, a taxpayer may transfer an unlimited amount of property to qualified charities.[464]
>
> (4) A taxpayer may pay the medical expenses and college tuition of as many people as he or she pleases.[465]
>
> (5) With certain exceptions, a taxpayer may make an interest-free loan to a donee, as long as the cumulative amount owed by the donee to the taxpayer does not exceed $10,000.[466]
>
> (6) In addition to items (1) through (5), above, a taxpayer may transfer $600,000 of "taxable gifts" without incurring gift taxation.[467] By 2006, this amount will increase to $1 million. A married couple can double this amount.[468]

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458. PEAT & WILLBANKS, *supra* note 65, at 238.
459. *Id.*
460. *See generally* CANTOR & FRANKLIN, *supra* note 12, at 146-49.
461. If the taxpayer lacks the funds to make annual exclusion gifts in a particular year, one commentator suggests borrowing the money necessary to make such gifts. HOLZMAN, *supra* note 47, at 49-50.
462. I.R.C. § 2513.
463. I.R.C. § 2523.
464. I.R.C. § 2522.
465. I.R.C. § 2503(e).
466. I.R.C. § 7872.
467. I.R.C. § 2505.
468. *See generally* HARRISON TWEED & WILLIAM PARSONS, LIFETIME AND TESTAMENTARY ESTATE PLANNING 40-43 (1988).

V. THE NEED FOR ANNUAL EXCLUSION REFORM

The need for annual exclusion reform cannot be overstated. There is no question that "[t]he amount of the exclusion and the type of interest that qualifies for the exclusion are important to accomplishing the exclusion's limited purpose. A large exclusion with no limitations on qualifying interests would impair the estate tax protective function of the gift tax."[469] Consequently, for decades commentators have proposed various reform measures,[470] and reform legislation has been proposed by various law reform commissions.[471] However, all of the reform proposals to date have dealt with annual exclusion reform on a piece-meal basis.[472] Each of these proposals would ease the problems associated with the annual exclusion, but none would solve them. Problems of this magnitude need a comprehensive solution, such as the one proposed below.

Any sensible annual exclusion reform should accomplish four goals: (1) simplify the application of the annual exclusion; (2) prevent estate tax avoidance; (3) promote fairness in the tax

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469. Steinkamp, *supra* note 28, at 167. The more than three-fold increase in the annual exclusion in 1981 enabled taxpayers to transfer substantial wealth without incurring transfer taxation. Carlson, *supra* note 173, at 322.

470. *See, e.g.*, BITTKER & CLARK, *supra* note 98, at 143-44 (embracing ABA Task Force proposal to maintain $10,000 per-donee exclusion but with a $30,000 annual cap); PEAT & WILLBANKS, *supra* note 65, at 92-94 (proposing a $2000 per-donee exclusion); SURREY ET AL., *supra* note 182, at 682-83 (proposal to eliminate exclusion for gifts in trust or, alternatively, to reduce per-donee exclusion to $1500); Steinkamp, *supra* note 28, at 167-79 (proposal to retain $10,000 per-donee exclusion but not to allow exclusion for mere income interests or transfers subject to lapsing demand powers); Osgood, *supra* note 188, at 316-19 (proposal to eliminate exclusion for most gifts in trust); Ascher, *supra* note 14, at 143 (proposal to reduce per-donee exclusion to $5,000).

471. A. JAMES CASNER, FEDERAL ESTATE AND GIFT TAXATION RECOMMENDATIONS 51-54 (1968) (proposing a $15,000 per-donor exclusion with the retention of the future interest rule); A. James Casner, *Proposed Tax Changes and Their Effect on Estate Planning*, *in* INST. ON EST. PLAN., 9-1, 9-5 (1969) (proposal to retain the $3,000 per-donee exclusion but with a $15,000 per-donor cap; also certain transfers for consumption were to be excluded).

472. *See, e.g.*, BITTKER & CLARK, *supra* note 98, at 143-44 (by retaining $10,000 per-donee exclusion, but with a $30,000 cap, ABA proposal discriminates against donors with more than three beneficiaries); PEAT & WILLBANKS, *supra* note 65, at 92-94 (the proposed $2000 per-donee exclusion is insufficient to cover large customary gifts like wedding and graduation presents); SURREY ET AL., *supra* note 182, at 682-83 (primary proposal would force donors to make outright gifts to young children; secondary proposal is insufficient to cover large customary gifts); Steinkamp, *supra* note 28, at 167-79 (proposal fails to set an upper limit on the amount of tax-free gifts a donor can make in a year); Osgood, *supra* note 188, at 316-19 (proposal would force donors to make outright gifts to young children); Ascher, *supra* note 14, at 143 (proposal would not prevent estate tax avoidance).

system; and (4) conform U.S. annual exclusion to the international norm. The challenge is to design an exclusion for inter vivos transfers in a form and at a level that realistically accounts for the transfer of customary gifts while maintaining the estate tax protective function of the gift tax.[473] This Article proposes such an exclusion.

A. *Complexity*

The annual exclusion is designed to exempt occasional small gifts from taxation. As such, it should be simple in form and application; there is no just reason for complexity. The only reason the annual exclusion is complex is because it is being used not to exempt birthday and holiday gifts from taxation, but rather to avoid estate tax. Complex tax-avoidance vehicles such as *Crummey* trusts and Section 2503(c) trusts run counter to the very purpose of the annual exclusion and should be abolished.[474] Simplicity is vital to an equitable system of taxation, as noted by one commentator:

> the law should be more certain. Taxpayers should not have to guess whether a particular transfer would qualify for the annual exclusion. Clear lines should exist over which even the most aggressive of taxpayers would not dare to step . . . . Gift and estate planning would be simplified if this goal is to be realized.[475]

The annual exclusion has been the product of more litigation than any other gift tax provision.[476] Determining which interests are present and which are future frequently results in protracted litigation. Fortunately, all of this complexity is avoidable.

An annual per-donor exclusion that places a strict, but realistic, limit on tax-free gifts is the only viable solution to the annual exclusion predicament. Such an exclusion will greatly simplify the application of the annual exclusion. For instance, with a per-donor exclusion, the distinction between future and present interests can be abolished, thus eliminating the need for tax-avoidance devices like *Crummey* trusts and Section 2503(c) trusts.

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473. Gutman, *supra* note 8, at 1245.

474. Casner, *supra* note 106, at 9-6 ("[T]he *Crummey* case presents an attractive arrangement . . . . The annual exclusion, when it can be used in this way, has become a sophisticated estate planning device that permits the accomplishment of goals other than the ones it was designed to achieve."). *See also* Richard S. Rothberg, *Crummey Powers Enhance the Usefulness of Trusts for Minors and Life Insurance Trusts*, 17 TAX'N FOR LAW. 132 (1988).

475. Steinkamp, *supra* note 28, at 167-68.

476. *See generally* Restrepo, *supra* note 359, at 133-35; SURREY ET AL., *supra* note 182, at 632; Sherman, *supra* note 196, at 585 ("The most troublesome and most frequently litigated issue in gift tax law is undoubtedly the availability of the "annual exclusion" authorized by section 2503(b)").

B. *Practical Abuse*

In practice, "the annual exclusion is not used by tax planners to cover casual or support transactions. Instead, the working assumption seems to be that gifts of cash or liquid assets . . . can be made on top of casual and support transactions, which are simply ignored."[477] "[D]espite its origin as a method of protecting wedding and Christmas gifts against tax, the exclusion has come to be thought of as an estate planning device for transfers *in addition* to birthday and Christmas gifts."[478] In fact, the annual exclusion is being used in a systematic effort to shield large transfers of securities, real estate, and cash to a donor's children, as though the donor gave them nothing else during the year.[479] Such abuse occurs, for example, when:

> A, a wealthy individual, has made an appointment to discuss her estate plan with you because X, her former attorney, died recently. Your appointment occurs early in December, and A reminds you of the need to make her annual gifts of $10,000 to each of her five children. "Wait a minute," you say. "Before making gifts of $10,000 to each child, I must know what amount you have already given each child in birthday, wedding, or graduation presents during the year." Although admitting that she has made lavish presents to her children during the year, A states that X never worried about such things and that if you are going to insist upon such an accounting, she will take her business elsewhere.[480]

As this hypothetical illustrates, the annual exclusion has become an "entitlement" for the wealthy,[481] and at $10,000 it has the potential to significantly erode the estate tax base.[482] This was neither the design nor the purpose of the exclusion. An annual per-donor exclusion, such as the one proposed below, will put an end to such practical abuse.

C. *Inequity*

The $10,000 annual per-donee exclusion fosters vertical tax inequity.[483] Vertical inequity occurs when tax benefits are available to some taxpayers but not to others. The annual exclusion is a paradigm of vertical tax inequity because only the

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477. Cooper, *supra* note 3, at 234.
478. Bittker, *supra* note 17, at 448 (emphasis added).
479. BITTKER & LAKKEN, *supra* note 21, at 124-3.
480. PEAT & WILLBANKS, *supra* note 65, at 74.
481. *Id.*
482. Gutman, *supra* note 8, at 1244.
483. PEAT & WILLBANKS, *supra* note 65, at 92.

super-wealthy are in a position to exploit the exclusion.[484] Moderately wealthy taxpayers, many of whom are exposed to estate tax at death, cannot afford to dispose of significant assets during life. The assets of these taxpayers will generally be subject to estate tax at rates up to fifty percent. By contrast, the super-wealthy can use the annual exclusion to reduce their ultimate estate tax burden.[485] Tax compliance demands vertical equity. The reform proposal set forth in this Article produces such equity.[486]

D. *Comparison with International Standards*

The U.S. $10,000 annual per-donee exclusion from gift taxation is not only unduly complex, inequitable, and susceptible to abuse, it is also inconsistent with the gift tax laws of most common law and civil law nations.[487] Four examples should suffice.

1. New Zealand

New Zealand imposes a duty on inter vivos gifts. Inter vivos gifts include outright transfers to a donee, as well as transfers to a trust for the benefit of a donee.[488] The duty is assessed on an annual, non-cumulative basis with rates ranging from five to twenty-five percent of the fair market value of the aggregate transfers made by the donor in a particular year.[489] Like most countries with a gift tax, New Zealand provides an annual exclusion for customary gifts. In particular, a gift duty is not imposed unless the aggregate inter vivos gifts made by the donor exceeds NZ$27,000 (approximately US$18,350)[490] in any one year.[491] In

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484. Gutman, *supra* note 8, at 1245 ("it is generally true that only those with large amounts of wealth can afford to dispose irrevocably of assets during life.").

485. *See* Ascher, *supra* note 14, at 143 ("The current level of $10,000 has been the subject of serious criticism. Not only is it an amount beyond the means of most people; those with persistence can use it to pass immense amounts outside the transfer tax system.").

486. Another means of obtaining vertical tax equity would be to abolish all estate and gift taxation. Australia and Canada have chosen this approach.

487. Some American citizens are expatriating to avoid estate and gift taxes. *See* Robert Lenzner & Philippe Mao, *The New Refugees*, FORBES, Nov. 21, 1994, at 131.

488. CLIFFORD J MANCER, GUIDE TO NEW ZEALAND ESTATE PLANNING AND TAX 295 (1994).

489. *Id.* at 293.

490. All of the exchange rates in this article were calculated on 1995-96 averages.

491. Mancer, *supra* note 488, at 295.

other words, New Zealand tax law provides a NZ$27,000 annual per-donor exclusion from gift tax.[492]

An annual per-donor exclusion set at a reasonable amount, such as that in New Zealand, safeguards the estate tax protective function of the gift tax. Unlike the U.S. annual exclusion, New Zealand's annual exclusion from gift taxation cannot be used to transfer vast amounts of wealth from generation to generation free of transfer tax.[493] As a consequence, New Zealand's annual exclusion provides a perfect model for annual exclusion reform in the United States.

2. The United Kingdom

Like New Zealand, the United Kingdom imposes a duty on inter vivos gifts. An inter vivos gift is a "transfer of property from one person to another gratuitously while the donor is alive and not in expectation of death."[494] "It is an act whereby something is voluntarily transferred from the true owner in possession to another person with the full intention that the thing shall not return to the donor."[495] An inter vivos gift may be made in three ways: (1) by deed or other instrument in writing; (2) by delivery in cases where the subject of the gift admits receipt; and (3) by declaration of trust.[496]

The maximum gift tax rate in the United Kingdom is forty percent. There are, however, certain exemptions from gift duty. For example, the United Kingdom has adopted a two-part annual exclusion. The first part is an annual per-donor exclusion of £3000 (approximately US$4850), which if unused can be carried forward one year.[497] The second part is an annual per-donee exclusion of £250 (approximately US$400).[498] By adopting a two-part annual exclusion, the United Kingdom is able to safeguard the estate tax protective function of the gift duty while exempting occasional small gifts from tax.[499]

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492. *Id.*

493. *See generally* R. A. Green & Lindsay McKay, *The Estate and Gift Duties Amendment Act of 1979: The Demise of Wealth Transfer Taxation*, 10 VICTORIA UNIV. WELLINGTON L. REV. 227 (1980).

494. 20 HALSBURY'S LAWS OF ENGLAND 2-3 (Lord Hailsham ed., 4th ed. 1993).

495. *Id.* at 2.

496. *Id.* at 3.

497. *Id.* at 3-4.

498. *Id.* Transfers between spouses and transfers to charities are also exempt from gift duty. INTERNATIONAL TAX SUMMARIES U-21 (George J. Yost, III ed., 1994).

499. *See generally* Charles H. Meyer, *Wealth Transfer Taxation: A Comparison of the Approaches in the United States and the United Kingdom*, 11 N.Y.U. J. INT'L L. & P. 1 (1978).

3. Japan

In Japan, gift tax is calculated on a calendar-year basis. All of the property a donee obtains by gift in a calendar year is aggregated to determine his or her tax liability.[500] Unlike most other countries, the gift tax in Japan is imposed on the donee.[501] The gift tax rates range from ten percent on the first ¥1.5 million to seventy percent on gifts over ¥100 million.[502] Japanese law, however, provides an exemption from gift taxation for the first ¥600,000 (approximately US$5000) of gifts obtained by a donee.[503] Although technically a per-donee exclusion, it is the equivalent of a per-donor exclusion in a country that imposes gift tax on the donor, such as the United States.[504] As such, Japan's annual exclusion is a prototype for reform legislation in the United States.

4. The Netherlands

In the Netherlands, a gift tax is imposed on gratuitous transfers of wealth made during life. The rate of tax varies from five to sixty-eight percent depending upon the amount of wealth transferred and the relationship between the donor and donee.[505] The gift tax is levied on the aggregate gifts obtained by a donee during a year.[506] The donee has principal liability for the gift tax. There is, however, an annual exemption from gift tax. For gifts from parents to children, the first Dfl. 7655 (approximately US$5300) of such gifts each year is exempt from taxation. The amount of this exemption is adjusted annually to counteract inflation.[507]

5. Summary of International Gift Tax Laws

When one examines the annual exclusions from gift taxation of New Zealand, the United Kingdom, Japan, and the Netherlands, two common themes emerge: (1) the annual exclusions from gift taxation are measured on a per-donor (or per-donor equivalent) basis; and (2) the amount of the annual exclusion is sufficient to exempt occasional gifts from taxation, yet modest enough to

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500. 5 DOING BUSINESS IN JAPAN, pt. X, § 1.11[3] (Zentaro Kitagawa, ed., 1994).
501. *Id.* § 1.11[1].
502. *Id.* § 1.11[3].
503. *Id.*
504. *See generally* HIROMITSU ISHI, THE JAPANESE TAX SYSTEM 223-30 (1993).
505. GERRIT T. SPENKE, TAXATION IN THE NETHERLANDS 157 (1995).
506. *Id.* at 153.
507. *Id.* at 156.

safeguard the estate tax protective function of the gift tax.[508] If exclusions of this sort are adequate in New Zealand, the United Kingdom, Japan, and the Netherlands, there is no reason a per-donor exclusion would not function just as well in the United States. The reform legislation proposed in this Article, therefore, is derived in large part from the gift tax laws of these countries.

VI. ANNUAL EXCLUSION REFORM

A. *Proposed Legislation*

Section 2503 (Proposed). TAXABLE GIFTS

(a) GENERAL DEFINITION. The term "taxable gifts" means the total amount of gifts made during the calendar year, less the deductions, provided in subchapter C (section 2522 and following).

(b) EXCLUSIONS FROM GIFTS. In the case of gifts made by the donor during the calendar year, the first $25,000 of such gifts shall not, for purposes of subsection (a), be included in the total amount of gifts made during such year. In addition to the $25,000 annual per-donor exclusion, in the case of gifts made to any person by the donor during the calendar year, the first $500 of such gifts to such person shall not, for purposes of subsection (a), be included in the total amount of gifts made during the year, nor shall such amount be included in the $25,000 exclusion set forth in the first sentence of this subsection.

(c) REPEALED

(d) REPEALED

(e) EXCLUSION FOR CERTAIN TRANSFERS FOR EDUCATIONAL EXPENSES OR MEDICAL EXPENSES.

(1) IN GENERAL. Any qualified transfer shall not be treated as a transfer of property by gift for the purposes of this chapter.

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508. India is another example of a country with a modest per-donor exclusion. In India, a gift tax is levied on the donor at a flat rate of 30% on the aggregate value of gifts exceeding Rs. 30,000 (approximately US$1,000) in a tax year. YOST, *supra* note 498, at I-15.

(2) QUALIFIED TRANSFER. For purposes of this subsection, the term "qualified transfer" means any amount paid on behalf of an individual—

(A) as tuition to an educational organization described in section 170(b)(1)(A)(ii) for the education or training of such individual, or

(B) to any person who provides medical care (as defined in section 213(d)) with respect to such individual as payment for such medical care.

(f) WAIVER OF CERTAIN PENSION RIGHTS. If any individual waives, before the death of the participant, any survivor benefit, or right to such benefit, under section 401(a)(11) or 417, such waiver shall not be treated as a transfer of property by gift for purposes of this chapter.

(g) TREATMENT OF CERTAIN LOANS OF ARTWORK

(1) IN GENERAL. For purposes of this subtitle, any loan of a qualified work of art shall not be treated as a transfer (and the value of such qualified work of art shall be determined as if such loan had not been made) if—

(A) such loan is to an organization described in section 501(c)(3) and exempt from tax under section 501(c) (other than a private foundation), and

(B) the use of such work by such organization is related to the purpose or function constituting the basis for its exemption under section 501.

(2) DEFINITIONS. For purposes of this section—

(A) QUALIFIED WORK OF ART. The term "qualified work of art" means any archaeological, historic, or creative tangible personal property.

(B) PRIVATE FOUNDATION. The term "private foundation" has the meaning given such term by section 509, except that such term shall not include any private operating foundation (as defined in section 4942(j)(3)).

(h) INDEXING. For purposes of this chapter, the amounts designated in subsection (b) shall be indexed for inflation in accordance with the method prescribed in section 1(f).

B. *Impact of the Reform Proposal*

The legislation proposed in this Article creates a two-part annual exclusion, derived in part from the annual exclusions of New Zealand, Japan, the United Kingdom, and the Netherlands. Briefly stated, Proposed Section 2503(b) creates a $25,000 annual per-donor exclusion as well as a $500 de minimus per-donee exclusion. In addition, the proposed legislation abolishes the future interest rule and repeals Section 2503(c), but retains Sections 2503(e), (f), and (g).

As stated above, any sound proposal to reform the annual exclusion should accomplish four goals: (1) simplify the application of the annual exclusion; (2) prevent estate tax avoidance; (3) promote fairness in the tax system; and (4) conform the U.S. annual exclusion to the international norm. Proposed Section 2503 attains each of these objectives, as illustrated by the following list of advantages of the proposed legislation:

- Under the proposed legislation, the distinction between present and future interests is abolished. Because a $25,000 cap is placed on the amount of transfers a donor may make in a calendar year, there is no longer any need for the distinction. As long as the transfer is complete for gift tax purposes, it does not matter whether it is made in the form of a present interest or a future interest. A donor may only transfer $25,000 per year, in addition to the $500 de minimus per-donee exclusion. This $25,000 includes all gratuitous transfers made by the donor in a calendar year. If a donor wishes to allocate part of his or her $25,000 annual exclusion to future interests, so be it.[509]

- Eliminating the distinction between present and future interests will greatly simplify the gift tax laws. No longer will taxpayers have to speculate as to which interests qualify for exclusion. This certainty, in turn, should result in a significant decrease in gift tax litigation. For many estate planners, however, the proposed legislation may result in decreased billable hours.

- Absent the distinction between future interests and present interests, tax-avoidance devices like Section 2503(c) trusts and *Crummey* trusts will become obsolete. In fact, the proposed legislation repeals Section 2503(c). These devices are nothing more than gimmicks used by donors to obtain the annual exclusion for future interests. Because future

509. The only viable alternative to this proposal would be to disallow the exclusion for all gifts in trust. This would, however, result in more complexity as estate planners would simply create trust-like vehicles in which to make transfers. It would also force some donors to make outright transfers of property to young children.

interests are entitled to the exclusion under the proposed legislation, such gimmicks will no longer be necessary.

- The proposed legislation creates a $25,000 annual per-donor exclusion. Because it is a per-donor exclusion, it is not susceptible to estate tax avoidance. Except for the $500 de minimus exception, the maximum amount a donor can transfer each year is $25,000. A married couple can double this amount.[510] Under the current $10,000 annual per-donee exclusion, donors are able to transfer millions of dollars a year tax-free.[511]

- This amount is more than sufficient to exempt customary gifts from taxation, which, of course, is the true purpose of the annual exclusion.

- The proposed legislation is consistent with the two main purposes of the annual exclusion. First, under the $500 de minimus per-donee exception, a donor may transfer up to $500 per year to as many donees as he or she pleases without incurring gift tax and without consuming any part of the $25,000 per-donor exclusion. The de minimus per-donee exception will eliminate the need to account for and report most small gifts, one of the purposes of the annual exclusion. More importantly, a de minimus per-donee exception of only $500 is not susceptible to abuse because the transaction costs associated with the traditional abusive practices far exceed $500. Second, the $25,000 per-donor exclusion ensures that customary gifts, such as birthday and holiday presents, are exempt from gift taxation. This is the main purpose of the annual exclusion. The per-donor exclusion, however, is also sufficient to exempt most larger, infrequent gifts from taxation, such as graduation presents and wedding gifts.

- The proposed two-part annual exclusion is consistent with the gift tax laws of other industrialized nations. The $500 de minimus per-donee exclusion is similar to the annual exclusion in effect in the United Kingdom, and the proposed $25,000 annual per-donor exclusion is similar to the annual exclusion in effect in New Zealand. In fact, an annual per-donor exclusion of $25,000 is more generous than the annual exclusions of any of the countries surveyed.

- Some commentators have objected to the adoption of a per-donor exclusion on the basis that "[i]f Taxpayer A can give each of his three children $10,000 per year free of tax, Taxpayer B should be allowed to give each of his six children $10,000 per year free of tax."[512]

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510. I.R.C. § 2513.
511. I.R.C. § 2503(b).
512. Steinkamp, *supra* note 28, at 170-71.

- The proposed legislation solves this problem by implementing both a per-donor exclusion and a per-donee exclusion. Under the proposed legislation, a donor with twenty children can give each of them $500 without consuming any part of his or her $25,000 annual per-donor exclusion. If the donor wishes to make gifts in excess of $500 to a single donee, the cumulative amount of all excess gifts may not exceed $25,000 without incurring gift taxation. This two-part annual exclusion is entirely consistent with the original purpose of exempting customary gifts from taxation.

- The proposed legislation establishes vertical equity in the gift tax system. The super-wealthy will no longer be able to use the annual exclusion as an estate tax avoidance device. Under the proposed legislation, all taxpayers (at least those subject to transfer tax) are treated equally. This, of course, will result in a significant increase in gift tax revenue.

- The proposed legislation has several practical components. First, the amounts specified in the proposed legislation will be indexed for inflation each year.[513] This will ensure tax equity for future generations.[514] Second, the exclusion for educational and medical expenses has been retained. Finally, for purposes of consistency and fairness, Sections 2503(f) and (g) have been retained.

VII. CONCLUSION

The gift tax annual exclusion is an excessively complex, inequitable device that is being used by U.S. citizens to evade transfer taxation. It is arguably the most exploited loophole in the transfer tax system. Absent meaningful reform, the annual exclusion will continue to be used as a vehicle for transferring millions of dollars from generation to generation free of gift tax, estate tax, and generation-skipping tax.

This Article proposes sensible reform legislation designed to remedy the defects in the annual exclusion. If enacted by Congress, the proposed legislation would create a system of taxation that is fairer, simpler, and more effective at generating federal revenue. The proposed legislation also conforms the U.S annual exclusion to the gift tax laws of most other industrialized countries.

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513. I.R.C. § 2503(e).
514. *See generally* DOUGLAS A. KAHN, FEDERAL INCOME TAX 4-5 (1994).

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