A SIMPLER VERIFIABLE GIFT TAX

Wendy C. Gerzog*

Abstract

The author proposes reforms to simplify the current federal gift tax system, foster uncomplicated outright transfers, eliminate valuation distortions, and increase taxpayer return compliance. In order to obtain those results, the author's simpler verifiable gift tax would incorporate hard-to-complete rules of transfer taxation, harmonize the gift and estate tax regimes, and grant gift tax preference inducements to encourage the filing of timely gift tax returns.

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I. INTRODUCTION

The purpose of this article is to create a simpler and more accountable federal gift tax.[1] In order to do that, this author proposes to address the issues of (1) valuation distortions; (2) gift completion rules; (3) current preferences for lifetime gifts; and (4) compliance.

Present law provides the opportunity for attorneys and their clients to benefit by infusing complexity into the gift tax system[2] and has penalized those taxpayers who have opted not to adopt convoluted, empty contrivances. It is time to adopt a rule of law that encourages and rewards simplicity.[3] When the taxpayer complicates valuation, the value of his or her property interest should be interpreted in a way adverse to that taxpayer's interest.[4] This position is justified by: (1) the element of taxpayer volition unaccompanied by any reasonable rationalization (apart from slashing transfer tax liability) for the taxpayer's employing the convolution; (2) the lack of a business-world counterpart to using entities to reduce the value of a company's assets without a business-motivated rationale; and (3) the unwarranted revenue loss from the resulting discounted valuation and from the increased revenue costs (auditing, appraisals, and litigation) that accompany these tortuous transactions. Essentially, the law should be reformed so that

[1] While similar abuses are found in other areas of taxation, even in other transfer tax areas like in the estate tax, this article is focused on a discussion of the federal gift tax system. Also, while the gift, income, and estate tax charitable deduction rules need to be changed to curtail abuses, and the gift and estate marital deduction provisions should be reformed to reflect an equal partnership and power between the spouses, they are beyond the purview of this article. This author has written about some of those charitable and marital deduction issues in other articles. *See, e.g.*, Wendy C. Gerzog, *Alms to the Rich: The Façade Easement Deduction,* 34 VA. TAX REV. 229 (2014); Wendy C. Gerzog, *The New Super-Charged PAT (Power of Appointment Trust)*, 48 HOUS. L. REV. 507 (2011); Wendy C. Gerzog, *From the Greedy to the Needy,* 87 OR. L. REV. 1133 (2009); Wendy C. Gerzog, *The Marital Deduction QTIP Provisions: Illogical and Degrading to Women*, 5 UCLA WOMEN'S L.J. 301 (1995). This article will also not cover the capital gains and gift and bequest basis issues, although this author's opinions on these issues are much in line with Professor Dodge's proposal for deemed realization. *See generally* Joseph M. Dodge, *A Deemed Realization Approach Is Superior to Carryover Basis (and Avoids Most of the Problems of the Estate and Gift Tax)*, 54 TAX L. REV. 421 (2001). While capital gains rates, basis rules, and transfer tax rates clearly overlap with each other, affecting realizations and the timing of transfers, that analysis is also beyond the scope of this article. On that issue, see, STAFF OF JOINT COMM. ON TAX'N, 112TH CONG., MODELING THE FEDERAL REVENUE EFFECTS OF CHANGES IN ESTATE AND GIFT TAXATION 21 (Joint Comm. Print 2012).

[2] *See, e.g.*, Jeffrey N. Pennell, *Wealth Transfer Taxation: 'Transfer' Defined,* 128 TAX NOTES 615 (Aug. 9, 2010) ("Valuation is the most controversial and pervasive topic in estate planning today. Much valuation controversy reflects 'value' used as a verb: how value is determined and how it is altered for wealth transfer tax purposes. . . . There is little more than general bromides that are principled, concrete, or reliable that can be gleaned from one situation and transported to another.").

[3] One of the fundamental goals of a tax system is simplicity. *See* Dept. of the Treas., Blueprints for Basic Tax Reform (Treas. Report Jan. 17, 1977) ("The first part of this report is devoted to clarifying the goals of the tax system, attempting to give specific content to the universally recognized objectives of equity, efficiency, and simplicity."); Dept. of Treas., 1 Tax Reform for Fairness Simplicity and Economic Growth 15 (Treas. Report Nov. 27, 1984) ("An important goal of the Treasury Department study of fundamental tax reform is simplification."). In addition, the goal of simplicity in the transfer tax area is reflected in the Supreme Court's holding in *Robinette v. Helvering*, 318 U.S. 184 (1943). *See Lockard v. Comm'r*, 166 F.2d 409 (1st Cir. 1948); Steinberg v. Comm'r, 141 T.C. 258 (2013); *infra* text accompanying notes 7–10.

[4] *See* Robert N. Macris, *Open Valuation and the Completed Transfer: A Problem Area in Federal Gift Taxation*, 34 TAX L. REV. 273, 304 (1978) ("[T]he real point [of *Robinette*] was that the donor, despite the retention of an interest, would be taxed on the amount of the entire transfer when the value of the retained interest was not of certain value.").

"tax minimization" is not equated with an artifice that undermines the integrity of the tax system itself. [5]

In *Robinette v. Helvering*, the donor created a reversionary interest that depended not only on survivorship but also on her daughter's death without issue surviving to age 21.[6] The Supreme Court stated:

> It may be true . . . that trust instruments . . . frequently create 'a complex aggregate of rights, privileges, powers and immunities . . . .' But before one . . . is entitled to deduction from his gift tax on the basis that he had retained some of these complex strands it is necessary that he at least establish the possibility of approximating what value he holds.[7]

A broadened corollary to this holding that seems appropriate and more than timely in the context of family entity discounts is that when a taxpayer creates such an entity and transfers liquid assets to it in order to obtain valuation discounts for estate planning purposes, he or she is no longer a seller under the fair market value definition[8] and is outside the real business world where such interests are generally traded. Indeed, the government's valuation expert in *Holman v. Commissioner* shined a light on the reality of these contrivances when he stated that it was unlikely that a third party would accept the sale or use restrictions of the family limited partnership (FLP) agreement; clarifying on cross-examination, he said: "What I mean is . . . the issue [of transfer restrictions] wouldn't arise, *because nobody at arm's length would get into this deal*."[9]

Thus, the first rule in a simpler verifiable gift tax is a valuation rule intended to strip interests in such taxpayer-created non-business family entities of any illiquidity (non-transferability) and minority discounts[10] under the theory that when one creates a family estate planning contrivance, no tax benefits should be available to reduce the value of the entity's underlying assets. By disallowing those tax benefits, in addition to the cost of creating and maintaining such family entities,[11] despite claims to the contrary,[12] no one would create these devices.

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[5] *See, e.g.*, *Erhard Seminars Training v. Comm'r*, 52 T.C.M. (CCH) 890 (1986) ("While a taxpayer has the right to minimize his taxes by whatever means the law permits, this right does not bestow upon the taxpayer the right to structure paper arrangements that do not stand on the solid foundation of economic reality.").

[6] *Robinette*, 318 U.S. at 188.

[7] *Id.*

[8] *See* Wendy C. Gerzog, *Valuation Discounting Techniques: Terms Gone Awry,* 61 TAX LAW. 775 (2008) (explaining that the fair market value definition in Treas. Reg. § 20.2031-1(b) implicitly requires a seller (the asset holder) to want to maximize the value of an asset in order to supply the proper tension with the buyer who wants to minimize cost. A seller who wants to minimize the value of his property is not, by any reasonable definition, a seller.).

[9] Holman v. Comm'r, 130 T.C. 170, 198 (2008) (emphasis added) (internal quotation marks omitted).

[10] As suggested in the text, there would be one exemption from the simple valuation rule: a family business exemption, which would require an ongoing, active family business and not one created or maintained primarily for the management or holding of investments.

[11] *See, e.g.,* Kiara Ashanti, *What Is a Family Limited Partnership (FLP) – Pros & Cons*, MONEY CRASHERS: YOUR GUIDE TO FINANCIAL FITNESS, *available at* http://www.moneycrashers.com/family-limited-partnership-flp/ ("Setting up an FLP can cost anywhere between $5,000 to $10,000 dollars [sic] with ongoing costs after setup."); *Frequently Asked Questions About Family Limited Partnerships*, THE TEXAS PROBATE WEBSITE, *available at* http://www.texasprobate.net/faqs/flpfaq.htm ("Because the organizational costs can be substantial, families with business assets of less than $2 million rarely find it advantageous to establish an FLP.").

The second rule in a simpler gift tax would be to adopt a hard-to-complete rule of transfer taxation.[13] That change from the current system would eliminate much of the confusion generated by the gift completion regulations[14] and would eliminate the tax abuses that have sprung from section 2702, including the ability to create ladders of short-term GRATs.[15]

Under the simpler gift tax proposal, for a gift to be complete, the donor must relinquish all interests in, and control over, the transferred property. Instead of drawing unsatisfying lines among different divestments of control and of relying on actuarial techniques that may be manipulated to avoid transfer tax, a simple gift tax would apply only to transfers with the donor's complete renunciation of all interests and control in the property. Retained interests or powers would constitute incomplete gratuitous transfers that would be taxed in the donor's estate.[16] That simple rule would coordinate well with the estate tax provisions and would eliminate instances where a transfer could under current law be subject to both transfer taxes,[17] albeit with present law offsets in the calculations of the estate tax to prevent double taxation.[18] That rule would deny the donor of complex transfers the benefit of value freezing and any additional benefits available for lifetime transfers.[19] That rule would also encourage outright transfers of property.

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[12] *See, e.g.*, Owen G. Fiore, *FLPs Are Good Business, Not a Party or Game*, 99 TAX NOTES 289 (2003).

[13] This article does not analyze the effects of carryover gift tax basis rules.

[14] *See* Treas. Reg. § 25.2511-2.

[15] GRAT is an acronym for a grantor retained annuity trust. Because of valuation abuses in the area of grantor retained interest gifts, wherein the retained interest was overvalued in order to undervalue the grantor's gift, most grantor retained interests are given a zero value under the provisions of I.R.C. § 2702. *See* I.R.C. § 2702 (2012). GRATs, wherein the transferor retains an annuity interest in a trust, are specifically allowed under that Code section to permit the value of the transferred property to be reduced by the actuarially determined value of the annuity interest because that type of fixed retained interest was deemed to be a more reliable measure of the grantor's retained interest than the more easily manipulated retained variable income interest. However, if the value of the annuity is fixed at a very high amount, the transferred interest may be valued at or near zero. In Walton v. Commissioner, 115 T.C. 589 (2000), *acq.*, 2003-2 C.B. 964, the Tax Court invalidated then Example 5 of Treas. Reg. § 25.2702-3(e), but also implicitly validated the donor's use of short-term two-year zeroed-out GRATs that can effectuate tax-free transfers. *See* JOSEPH M. DODGE, WENDY C. GERZOG & BRIDGET J. CRAWFORD, FEDERAL TAXES ON GRATUITOUS TRANSFERS: LAW AND PLANNING 451-53 (2011) [hereinafter DODGE, GERZOG, & CRAWFORD].

[16] Other scholars have proposed rules to deal with valuation problems and gift completion. *See, e.g.*, Mitchell M. Gans, *Gift Tax: Valuation Difficulties and Gift Completion,* 58 NOTRE DAME L. REV. 493, 536 (1983) ("Thus, the valuation-difficulty rule should be applied to all gifts not immediately capable of valuation if: (1) an interest charge is imposed to neutralize the deferral; (2) only those post-severance events of a revelation character are permitted to enter the tax base; and (3) the death-completion rule is adopted to prevent tax avoidance.").

[17] For example, under Treas. Reg. § 25.2511-2(d) and 25.2511-2(e), respectively, gifts with donor retained control over the timing or manner of the gift and joint gifts that are made together with someone holding a substantial adverse interest to the exercise of a donor retained power are completed gifts; however, they are nonetheless subject to the estate tax under I.R.C. § 2036 or § 2038 if the donor has retained those powers at his death (or, under I.R.C. § 2035(a)(2) or § 2038, if he has released them within three years of his death). *See* I.R.C. §§ 2035(a)(2), 2036, 2038 (2012); Treas. Reg. § 25.2511-2(d)–(e); *see also Lober v. U.S.*, 346 U.S. 335 (1953); *Smith v. Shaughnessy,* 318 U.S. 176 (1943).

[18] *See* I.R.C. § 2001(b)(2) (2012). For further explication, see DODGE, GERZOG & CRAWFORD, *supra* note 15, at 449-50.

[19] *See infra* Part IV.

This article will review the present preferences allotted to gifts[20] and the policy considerations to justify them. Arguably, except for a small annual exclusion, there is no cogent argument to retain any of the other gift tax benefits. While this author thus acknowledges that she has not found convincing data that requires the preservation of most gift tax benefits, she nevertheless proposes that the simpler gift tax retain at least some of those preferences in order to encourage easily valued and reported lifetime transfers and to compensate for the revenue loss attached to the adoption of a hard-to-complete rule for gift tax gift completion.

Inevitably, the gift tax simplification rules would reduce the gift tax revenue now generated by complex transactions. Although the gift tax was created to generate current revenue,[21] in addition to serving as a backstop for both the estate tax[22] and the income tax,[23] this article suggests that by limiting or denying preferences for lifetime gifts under certain circumstances, the simplification and verification rules may serve to underline the tax saving accorded simple and reported taxable gifts that, in turn, may increase those preferred lifetime transfers, ultimately resulting in additional revenue.[24] In other words, while wealthy people may be all right with complex, attorney-involved strategies, they may actually prefer to make simple, tax-favored gifts.

However, the simpler gift tax proposal would make some changes to the exclusions currently provided under section 2503. Specifically, the annual exclusion would be reduced to $2,000 per donee per year in outright gifts in order to cover *de minimis* holiday or occasion gifts and to eliminate both tax-free wealth transfers of

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[20] The benefits include the exclusions under I.R.C. § 2503, a tax exclusive base, gift splitting, valuation freezing, and either passing the post-gift income to a lower bracket donee or creating an intentionally defective grantor trust ("IDGT"). *See infra* Part IV. Creating an IDGT is a way of freezing the value of the asset by making a taxable gift. As the owner of income under the grantor trust rules, the grantor can further reduce his taxable estate by paying the income taxes on the income without incurring an additional gift tax for those income tax payments, which legally are the grantor's own income tax liabilities. *See* STAFF OF JOINT COMM. ON TAX'N, 112TH CONG., MODELING THE FEDERAL REVENUE EFFECTS OF CHANGES IN ESTATE AND GIFT TAXATION 24 (Joint Comm. Print 2012).

[21] *See* STANLEY S. SURREY ET AL., FEDERAL WEALTH TRANSFER TAXATION: CASES AND MATERIALS 5 (3d ed. 1987) ("By 1932 the country had entered into the years of depression. Reduced tax yields from the falling national income and increasing expenditures brought about deficits. Congress, in trying to overcome the deficits, not only adopted the gift tax and increased the income tax rates but also strengthened the estate tax. . . . Thus in 1932 Congress decided that the transfer taxes should be an important source of revenue to the federal government."); Jeffrey A. Cooper, *Ghosts of 1932: The Lost History of Estate and Gift Taxation*, 9 FLA. TAX REV. 875, 913 (2010) (explaining that the gift tax was enacted to provide incentives for making current taxable gifts in order to produce much needed revenue during the Depression; "In effect Congress told wealthy taxpayers, you can pay us now or you can pay us later. But, they added one key proviso: If you pay us now, you'll pay far less. The gift tax thus wasn't designed to prevent estate tax avoidance. Rather, it was carefully designed to encourage such avoidance.").

[22] H.R. REP. NO. 72-708, at 8 (1932); S. REP. NO. 72-665, at 11 (1932); *see United States v. Irvine*, 511 U.S. 224, 234 (1994); *Smith v. Shaughnessy*, 318 U.S. 176, 179 ("[T]he gift tax serves to supplement the estate tax."); *Sanford's Estate v. Comm'r*, 308 U.S. 39, 44 (1939).

[23] H.R. REP. NO. 72-708, at 8 (1932); S. REP. NO. 72-665, at 11 (1932); *see Smith v. Shaughnessy*, 318 U.S. at 179 n. 1 ("The gift tax was passed not only to prevent estate tax avoidance, but also to prevent income tax avoidance through reducing yearly income and thereby escaping the effect of progressive surtax rates."); *Sanford's Estate*, 308 U.S. at 47 ("One purpose of the gift tax was to prevent or compensate for the loss of surtax upon income where large estates are split up by gifts to numerous donees.").

[24] To boost current revenue, the government may also want to consider touting the benefits of making these simple tax-favored gifts. The simpler verifiable gift tax will make marketing lifetime gifts more accessible and hence much easier to promote.

greater amounts and *Crummey*[25] trusts. While limiting the annual exclusion, which was intended to obviate the record-keeping difficulties involved in small gifts, this article proposes to amend trusts to minors under section 2503(c)[26] to allow "minor" trusts to extend the 2503(b) exclusion to cover donees until age 30. At that time, however, the trust would need to terminate and its assets be distributed.[27] The payout requirement of section 2503(c) at age 21 has always been a concern for donors[28] and most estate planners use techniques to discourage the termination of these trusts.[29] The new rule would alleviate that unease and shorten the actual term of minor trusts.

In addition, the simpler verifiable gift tax would expand the exclusion under section 2503(e) to other consumption type transfers. The amended statute would state that these exclusions, which are additional to the annual exclusion, are intended to cover consumption items and, therefore, do not apply to any transfer that, in fact, is primarily an unconsumed gratuitous property wealth transfer.

Currently, section 2503(e) excludes certain tuition and medical payments from the gift tax.[30] This article proposes three additions to this part of the exclusion statute: (1)

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[25] *See Crummey v. Comm'r*, 397 F.2d 82 (9th Cir. 1968). In a *Crummey* trust, "[e]ach beneficiary is given the power, exercisable annually, to withdraw from the trust an amount equal to the lesser of (a) the amount (if any) transferred to the trust by the grantor during that year or (b) an amount equal to the maximum annual exclusion. If the power is not exercised, the gift amounts become part of the trust corpus and cease to be subject to the demand power." DODGE, GERZOG & CRAWFORD, *supra* note 15, at 131. For a discussion of the case and an expanded discussion of a *Crummey* trust, see DODGE, GERZOG & CRAWFORD, *supra* note 15 at 131-41.

[26] I.R.C. § 2503(c) provides:

> No part of a gift to an individual who has not attained the age of 21 years on the date of such transfer shall be considered a gift of a future interest in property for purposes of subsection (b) if the property and the income therefrom--(1) may be expended by, or for the benefit of, the donee before his attaining the age of 21 years, and (2) will to the extent not so expended-- (A) pass to the donee on his attaining the age of 21 years, and (B) in the event the donee dies before attaining the age of 21 years, be payable to the estate of the donee or as he may appoint under a general power of appointment as defined in section 2514(c).

[27] Although commonly referred to as covering gifts to minors, "minors" is already a misnomer as the age of majority is now 18 and not 21 when the statute provides for termination and payment to the donee. Yet, even trust termination and payout at age 21 does not comport with the contemporary medical findings that young adults' brains are not completely formed until their mid-to-late twenties. *See, e.g.*, Tony Cox, *Brain Maturity Extends Well Beyond Teen Years*, NPR (Oct. 10, 2011), *available at* http://www.npr.org/templates/story/story.php?storyId=141164708 (interviewing Sandra Aamodt, neuroscientist and co-author of *Welcome to Your Child's Brain: How the Mind Grows from Conception to College*); A. Rae Simpson, *Brain Changes*, MIT YOUNG ADULT DEV. PROJECT (2008), *available at* http://hrweb.mit.edu/worklife/youngadult/brain.html#beyond (arguing that the brain is not fully developed until at least age 25). Thus, it is not surprising for donors today to be wary of creating these trusts and, consequently, this explains the employment of techniques to minimize the *actual* termination and payout at age 21. *See* DODGE, GERZOG, AND CRAWFORD, *supra* note 15, at 129–31.

[28] *See* James Casner, *American Law Institute Federal Estate and Gift Tax Project,* 22 TAX L. REV. 515, 530 (1967) ("The most troublesome aspect of the requirements has been that the beneficiary be entitled to the principal and any accumulated income when he reaches 21 if the gift of principal is to qualify for the exclusion.").

[29] *See* Bridget J. Crawford, *Reform the Gift Tax Annual Exclusion to Raise Revenue*, 132 Tax Notes 443 (July 25, 2011) (citing Rev. Rul. 74-43, 1974 C.B. 285) ("If the beneficiary has the right to withdraw all the trust property at age 21 but the trust continues if the beneficiary does not do so, the trust will still qualify for the annual exclusion.").

[30] I.R.C. § 2503(e) provides:

> (1) Any qualified transfer shall not be treated as a transfer of property by gift for purposes of this chapter. (2) For purposes of this subsection, the term "qualified transfer" means

an expanded section 2503(e) education exclusion that would cover "qualified higher education expenses" (as defined in section 529) while the donee is attending post-secondary school as, at least, a half-time student;[31] (2) an exclusion that would cover reasonable living expenses (food, clothing, and lodging) of any donee living in the same residence as the donor, regardless of age;[32] and (3) an exclusion that would apply to cash payments to any individual who provides care for a disabled person, including the donor, living in the donor's home as long as the payments bear a reasonable relationship to the services provided to the disabled person and all associated required state and federal employment and income taxes are timely paid. While payments to non-relatives generally fall outside of the gift tax under the "ordinary-course-of-business" exception in the gift tax regulations,[33] payments to relatives who perform care for their disabled relatives have at times been construed as taxable gifts.[34] The purpose of this added exclusion is to clarify under what circumstances payments to family and friend caregivers would be exempt from gift tax.

The author understands that the consumption exclusions indirectly add to the transferee's wealth, either by adding to her human capital (the ability to make more money because of an advanced education) or by allowing her to preserve her financial capital instead of having to use her investments to pay for the value of her living costs.[35] However, comparable to the exclusion for services,[36] consumption costs outlined in the proposed exclusion may be too elusive for most donors to consider their wealth transfer effect and, as such, produce administrative reasons not to subject those items to tax.

> 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.

[31] *See* I.R.C. § 25A(b)(3).

[32] This proposal is similar to but less restrictive than the one proposed by the American Law Institute ("ALI") in the 1960s. *See* Casner, *supra* note 28, at 538 (Explaining an exclusion for transfers for current consumption cannot be one that results in the acquisition of property "if it is an expenditure for: (1) The benefit of a minor child of the transferor; or (2) Educational costs or medical or dental costs of an individual; or (3) Food, clothing, and maintenance of living accommodations of an individual and persons dependent on such individual that does not exceed $3000 annually.").

[33] *See* Treas. Reg. § 25.2512-8 (stating, in part: "However, a sale, exchange, or other transfer of property made in the ordinary course of business (a transaction which is bona fide, at arm's length, and free from any donative intent), will be considered as made for a full and adequate consideration in money or money's worth.").

[34] Many cases involving the issue of whether a transfer is a bequest or a valid claim against the estate under I.R.C. § 2053 rest on presumptions under state law, which, when facts of an employment agreement are ambiguous, often presume services provided to family members to be gratuitous. Having a clear exclusion may obviate the need for such litigation. *See e.g.,* Olivo v. Comm'r, T.C.M. 2011-16 (applying New Jersey law presumption); Estate of Wilson v. Comm'r, T.C.M. 98-309 (finding payments by the executor to two brothers, distant relatives of the decedent's predeceased husband, who consecutively performed services for the decedent, elderly and suffering from severe diabetes and its consequences (blindness and leg amputation), were held to be for adequate consideration in money or money's worth). In Wilson, the court upheld an oral compensation agreement because it found that the agreement was between nonrelatives who were not the natural objects of the decedent's bounty and, like unrelated third parties, were both service providers engaged the estate in litigation and settlement.

[35] *See* SURREY, *supra* note 21, at 696 (". . . [T]he payment of certain educational and medical expenses where the donor has no legal obligation to support the donee constitute transfers properly subject to tax."); Paul L. Caron, *Taxing Opportunity*, 14 VA. TAX REV. 347, 423 (1994) (advocating the limitation of the gift tax exemption for services to those that "the parents do not provide to third parties.").

[36] *See Comm'r v. Hogle*, 165 F.2d 352 (10th Cir. 1947).

Additionally, there are non-tax reasons[37] to allow some of these new exemptions: encouraging education[38] and the care of disabled family members by family members,[39] especially with the dearth of caregivers nationwide.[40]

Finally, a verifiable gift tax means better taxpayer compliance with the gift tax filing and payment requirements, which are increasingly ignored rather than timely satisfied.[41] In their recent article,[42] Professors Gans and Soled have noted the dismal compliance rate for gift tax returns due to the lack of consequences and enforcement tools in this area[43] and have suggested the imposition of filing of mandatory donee information returns in order to confirm the information on the donor's required return[44] and of new penalties on delinquent donors.[45] While their arguments are convincing, this article proposes an alternative solution to what this author also sees as very real problems.

As stated, there are benefits to making lifetime gifts. Among those benefits are the unified credit (currently exempting $5.43 million when combined with the estate tax credit),[46] the annual exclusion (both the current one and as modified under this proposal),[47] and the gift tax tax-exclusive tax base.[48] Adopting something like the

[37] SURREY, *supra* note 21, at 696.

[38] *See, e.g.*, 529 REPORT (Coll. Sav. Plans Network, Lexington, Ky.), Sep. 2014, Tax Analysts' Document Service, Doc. 2014-21949 ("Education is the key to unlocking the door to opportunity. Throughout the past several years, new research continues to provide supportive evidence that a college degree not only increases the economic earning power of both individuals and our national economy, but it is also proven to contribute to improved health, homeownership, voting rates, community volunteerism and other social benefits.").

[39] *See* National Family Caregiver Support Act, Pub. L. No. 106-501, 114 Stat. 2253 (2000) (codified as amended at 42 U.S.C. §§ 3030s to 3030s-2 (2012)). For information about sponsored programs, see *Administration on Aging (AoA): National Family Caregiver Support Program (OAA Title IIIE)*, ADMIN. FOR CMTY. LIVING, U.S. DEP'T OF HEALTH AND HUMAN SERVS. *available at* http://www.aoa.gov/aoa_programs/hcltc/caregiver/index.aspx. Under the income tax system, payments to relatives, as defined under I.R.C. § 152(d)(2)(A)–(G), for long term care for the "chronically ill" are denied medical care deductions. *See* I.R.C. §§ 213(d)(11), 7702B(c). These are income tax issues and thus not within the scope of this article; however, this author would welcome a change in those provisions as well. Abuse in this area can better be dealt with by requiring proper and timely income and work-related filing and tax payments in order to receive a deduction or other income tax benefit.

[40] *See, e.g.*, Walt Zywiak, Global Inst. for Emerging Healthcare Practices, *U.S. Healthcare Workforce Shortages: Caregivers*, COMPUTER SCIENCES CORP. (May 2013), *available at* http://assets1.csc.com/health_services/downloads/CSC_US_Healthcare_Workforce_Shortages_Caregivers.pdf.

[41] Mitchell M. Gans & Jay A. Soled, *Reforming the Gift Tax and Making it Enforceable*, 78 B.U. L. REV. 759, 775 (2007) (noting that "compliance with the gift tax appears to be ebbing.").

[42] Mitchell M. Gans & Jay A. Soled, *Reforming the Gift Tax and Making it Enforceable*, 78 B.U. L. REV. 759 (2007).

[43] *Id.* at 776 ("When it comes to gift tax enforcement, however, the issuance of any third-party information returns is noticeably absent, and there is no self-policing mechanism in place.").

[44] *Id.* at 793–95 (suggesting a requirement of information returns and aggregated multiple gifts from individual information returns, aggregating multiple gifts, from individual donees for outright gifts and from trustees for transfers in trust).

[45] *Id.* at 795–96. None of the penalties would be determined with reference to the taxpayer's actual gift tax liability because they would be computed without taking into account the credit exemption amount. *Id.* The authors ask Congress "to institute reporting mechanisms that facilitate IRS oversight and a penalty system that taxpayers will think twice about before violating." *Id.* at 799.

[46] *See* I.R.C. § 2010. Beginning with 2012, the $5 million exemption equivalent is indexed for inflation. I.R.C. § 2010 (c)(3)(B). In 2015, that indexed exemption equivalent is $5.43 million. *See* Rev. Proc. 2014-61, 2014-47 I.R.B. 860 § 3.33 ("For an estate of any decedent dying during calendar year 2015, the basic exclusion amount is $5,430,000 for determining the amount of the unified credit against estate tax under § 2010.").

[47] *See infra* Part IV.

portability[49] filing requirement,[50] in which the surviving spouse only receives the deceased spouse's unused exemption amount if a timely return is filed, this article proposes to deny one, two, or all of the gift tax benefits to a donor who is required to, but does not, file a gift tax return.

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[48] The estate tax differs from the gift tax in that the estate tax, like the income tax, is a tax-inclusive tax. *See* DODGE, GERZOG & CRAWFORD, *supra* note 15, at 8, 46, 349 n.46. That is, assets used to pay the estate tax liability are themselves subject to estate tax. *Id.* A benefit of the gift tax is that the money used to pay gift tax liability is not itself subject to gift or estate tax and yet it diminishes the donor's estate. *Id.*

[49] The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 §§ 302(a)(1) & 303(a), Pub. L. No. 111-312, 124 Stat. 3296, 3302–04, amended I.R.C. § 2010(c) by enacting a temporary "portability" provision, applicable to decedents dying in 2011 and 2012, which allowed the deceased spousal unused exclusion amount to be applied to both the surviving spouse's gift and estate tax liabilities in addition to her own exemption amount. *See* DODGE, GERZOG & CRAWFORD, *supra* note 15, at 290. The American Taxpayer Relief Act of 2012 § 101(a), Pub. L. No. 112-240, 126 Stat. 2313 (2013), made those portability provisions a permanent feature of estate taxation. With the enactment of the portability provisions, § 2010(c)(2) defines the "applicable exclusion amount" as aggregating the surviving spouse's "basic exclusion amount" with her "deceased spousal unused exclusion amount." The surviving spouse's additional exclusion amount is defined as "the lesser of (A) the basic exclusion amount, or (B) the excess of–(i) the basic exclusion amount of the last such deceased spouse of such surviving spouse, over (ii) the amount with respect to which the tentative tax is determined under section 2001(b)(1) on the estate of such deceased spouse." I.R.C. § 2010(c)(4). On the topic of portability, SEE OUTSIDE THE BOX ON ESTATE TAX REFORM: REVIEWING IDEAS TO SIMPLIFY PLANNING: HEARINGS BEFORE THE S. FIN. COMM., 110TH CONG. 2 (2008) (TESTIMONY OF SHIRLEY M. KOVAR, CHAIR, TRANSFER TAX STUDY COMMITTEE, AMERICAN COLLEGE OF TRUST AND ESTATE COUNSEL); STAFF OF JOINT COMM. ON TAX'N, 110TH CONG., TAXATION OF WEALTH TRANSFERS WITHIN A FAMILY: A DISCUSSION OF SELECTED AREAS FOR POSSIBLE REFORM, (Joint. Comm. Print 2008); Bridget J. Crawford and Jonathan G. Blattmachr, *Planning With Portability Do-Overs (But Only for a Limited Time)*, 143 TAX NOTES 117 (2014) (outlining the temporary relief in Rev. Proc. 2014-18, 2014-07 I.R.B. 513); Bridget J. Crawford & Wendy C. Gerzog, *Portability, Marital Wealth Transfers and the Taxable Unit*, *in* CONTROVERSIES IN TAX LAW: A MATTER OF PERSPECTIVE (Anthony C. Infanti, ed., forthcoming Apr. 2015); Wendy C. Gerzog, *Portability of Exemptions*, 119 TAX NOTES 509 (2008) (discussing background material on portability); David Cay Johnston, *Patches, Portability, and Punting Versus an Estate Tax KISS*, 125 TAX NOTES 249 (2009); Fred Stokeld, *Senators, Witnesses Ponder Estate Tax Reform Options*, 119 TAX NOTES 15 (2008).

[50] Under I.R.C. § 2010(c)(5)(A), a portability election is effective only if made on a Form 706 that is filed within the time prescribed by law (including extensions) for filing such return. *See* Temp. Treas. Reg. § 20.2010–2T(a)(1) (2012), which provides:

> To allow a decedent's surviving spouse to take into account that decedent's deceased spousal unused exclusion ("DSUE") amount, the executor of the decedent's estate must elect portability of the DSUE amount on a timely-filed Form 706, ". . . Estate (and Generation-Skipping Transfer) Tax Return". . . . Accordingly, the due date of an estate tax return required to elect portability is nine months after the decedent's date of death or the last day of the period covered by an extension (if an extension of time for filing has been obtained). See §§20.6075-1 and 20.6081-1 for additional rules relating to the time for filing estate tax returns.

Likewise, Temp. Treas. Reg. § 20.2010–2T(a)(3)(ii) provides: "The executor of the estate of a decedent (survived by a spouse) will not make or be considered to make the portability election if . . . [t]he executor does not timely file an estate tax return in accordance with paragraph (a)(1) of this section." These temporary regulations were added by T.D. 9593, 2012-28 I.R.B. 17, were published in 77 Fed. Reg. 36150, 36157–60 on June 18, 2012, and are retroactively effective June 15, 2012. The applicability of the Temporary Regulations expires on or before June 15, 2015. Temp. Treas. Reg. § 20.2010-2T(f). The American Institute of Certified Public Accountants ("AICPA") has recently proposed easing the filing requirements for portability for those not required to file an estate tax return because the decedent's estate is below the filing dollar threshold, allowing those estates to file a 706-EZ form and allowing the surviving spouse to make the portability election. *AICPA Letter to IRS on Portability Relief*, AM. INST. OF CPAS (Mar. 19, 2015), *available at* http://www.aicpa.org/Advocacy/Tax/DownloadableDocuments/
aicpa_comments_on_portability_relief_extend_request-3-19%2015-submitted-es.pdf.

To comply with the portability rules for estate tax purposes, in order to allow the surviving spouse to benefit from the first-spouse-to-die's unused "unified credit" (by aggregating the decedent's unused credit amount with the surviving spouse's own credit exemption),[51] even if the decedent is not subject to estate tax, the executor is required to file an estate tax return for the purpose of computing, and permitting the porting of, the deceased spouse's unused spousal exemption.[52] In sum, without timely and proper filing of an estate tax return for portability purposes, the surviving spouse loses a potentially hefty tax benefit. Mirroring the portability requirement, denying sought-after gift tax preferences to non-filers should provide a sufficient and simple incentive for donor compliance.

II. VALUATION DISTORTIONS

Wealthy parents and grandparents create non-business entities, primarily FLPs and limited liability companies ("LLCs"), in order to devalue the almost entirely liquid (and therefore undiscounted) assets they transfer to those entities. Because the entity or state law imposes restrictions on the transferability of such entity interests, gifts of those interests are entitled to lack-of-marketability discounts. The values of those gifts are also generally entitled to a minority (lack of control) discount because holders of those interests cannot freely control the entity's assets.[53] Together, those discounts reduce the values of the transferred underlying assets to between 30-to-60 percent of their fair market value.[54]

In *Bongard*[55], the Tax Court merely required a showing of "the existence of a legitimate and significant nontax reason for creating the family limited partnership, and [that] the transferors received partnership interests proportionate to the value of the property transferred."[56]

Although urged by Judges Halpern and Laro in their separate opinions[57] to focus, respectively, on the ordinary-course-of-business exception under the regulations[58] and

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[51] *See* I.R.C. § 2010(c).

[52] *See supra* note 49.

[53] *See* DODGE, GERZOG & CRAWFORD, *supra* note 15, at 484–99. In addition, because the wealthy entity creators generally make gifts of minority interests in the entity and because, subsequent to that gift-giving, the parents or grandparents hold a minority share in the entity at their deaths, minority interest discounts also apply to further decrease the value of any gifts or bequests. *Id.*

[54] *See* Martha Britton Eller, *Which Estates Are Affected by the Estate Tax?: An Examination of the Filing Population for Year-of-Death 2001*, STATS. OF INCOME BULL., Summer 2005, at 185, 197, *rev. ed. available at* http://www.irs.gov/pub/irs-soi/01esyod.pdf ("According to IRS estate and gift tax attorneys, who review and audit Federal estate tax returns, and various private-sector studies of valuation discounting, recent discounts of FLP interests fall between 30 percent and 60 percent.").

[55] Estate of Bongard v. Comm'r, 124 T.C. 95 (2005). *See* Wendy C. Gerzog, *Bongard's Nontax Motive Test: Not Open and* Schutt, 107 TAX NOTES 1711 (June 27, 2005). The *Bongard* test is used to determine whether or not the "bona fide sale for adequate and full consideration" exception under § 2036 applies. While § 2036 is an estate tax provision, the bona fide sale exception refers to the decedent's lifetime transfer.

[56] Bongard, 124 T.C. at 118. According to the Tax Court, the nontax reason must be "a significant factor that motivated the partnership's creation" and it "must be an actual motivation, not a theoretical justification." *Id.* The family entity must also comply with the formal requirements of establishing a limited partnership or limited liability company and adhere to a proper sequence of events. *See* Hurford v. Comm'r, 96 T.C.M. (CCH) 422 (2008); Senda v. Comm'r, 433 F.3d 1044 (8th Cir. 2006), *aff'g* T.C.M. (RIA) 2004-160.

[57] Judge Laro concurred in the result in *Bongard*. 124 T.C. at 133. Judge Halpern concurred in part and dissented in part. 124 T.C. at 141.

similar case law,[59] the Court rejected that analysis and diverged from gift tax basics and the primarily non-motive focus of the gift definition statute, which effectively inhibits abuse.[60] The Court crafted its own two-prong approach, which unfortunately introduced motive as determinative [61] and has improperly equated proportionality with the fundamental gift tax tenet that to avoid the transfer tax, there must be an equivalent exchange in money or money's worth.[62] As a result, application of the court's *Bongard* test requires a fact-intensive inquiry with inconsistent and unpredictable results.[63]

The Court in *Bongard* listed factors that demonstrated the lack of a nontax purpose: (1) the taxpayer stands on both sides of the transaction; (2) the taxpayer needs partnership distributions for his maintenance and support; (3) the partners commingle partnership assets with their own; and (4) the taxpayer does not transfer the property to the FLP.[64] With such minimal requirements, some taxpayers have prevailed in asserting the following purported "nontax motives": gift giving and estate planning[65] (including providing funds to pay the donor's gift tax or the decedent's estate tax liabilities),[66] creditor or asset protection,[67] protection from property division in the event of a divorce,[68] centralized asset management,[69] maintaining and retaining family assets,[70] encouraging family harmony and reducing litigation expenses from family

[58] Treas. Reg. § 25.2512-8 ("However, a sale, exchange, or other transfer of property made in the ordinary course of business (a transaction which is bona fide, at arm's length, and free from any donative intent), will be considered as made for an adequate and full consideration in money or money's worth."); Treas. Reg. § 25.2511-1(g)(1) ("The gift tax is not applicable to a transfer for a full and adequate consideration in money or money's worth, or to ordinary business transactions . . . ."). Judge Halpern criticized the majority's deviation from the regulations by imposing a motive test: "By the explicit terms of section 25.2512-8, Gift Tax Regs., the resulting inquiry is limited to an economic calculus, and there is no room for any inquiry as to the transferor's (decedent's) state of mind." *Bongard*, 124 T.C. at 144 (concurring in part and dissenting in part).

[59] Judge Laro maintained that the court should continue to apply the *Gregory v. Helvering*, 293 U.S. 465 (1935), business purpose test, cited by the Third Circuit in *Estate of Thompson v. Commissioner*, 382 F.3d 367, 383 (3d Cir. 2004). *Bongard*, 124 T.C. at 139 (concurring in result).

[60] Under I.R.C § 2512(b), a gift for gift tax purposes is defined as an unequal exchange in money or money's worth. *See* Comm'r v. Wemyss, 324 U.S. 303 (1945) (holding that transfers out of love and affection are not consideration in money or money's worth). Because the gift tax is concerned with transfers that result in a diminution of the donor's estate without imposing a gift tax, its focus differs from the test for a gift for income tax purposes, which, under *Commissioner v. Duberstein*, 363 U.S. 278 (1960), requires donative intent. Indeed, the role of donative intent is minimal in gift tax law. *See* Treas. Reg. § 25.2511-1(g)(1) ("Donative intent on the part of the transferor is not an essential element in the application of the gift tax to the transfer.").

[61] As Judge Halpern stated in *Bongard*, "By the explicit terms of section 25.2512-8, Gift Tax Regs., the resulting inquiry is limited to an economic calculus, and there is no room for any inquiry as to the transferor's (decedent's) state of mind." 124 T.C. at 144 (concurring in part and dissenting in part).

[62] *Id.* at 145 ("While an inquiry as to proportionality may have some bearing on whether the transfer was in the ordinary course of business, within the meaning of section 25.2512-8, Gift Tax Regs. (e.g., was at arm's length), I fail to see how proportionality aids the inquiry as to whether the value of the property transferred exceeded the cash value of the consideration received in exchange.") (footnote omitted).

[63] *See* Wendy C. Gerzog, *Tax Court FLP Confusion:* Mirowski, 120 TAX NOTES 263 (July 21, 2008).

[64] 124 T.C. at 118–19.

[65] *See* Estate of Schutt v. Comm'r, 89 T.C.M. (CCH) 1353 (2005).

[66] Estate of Mirowski v. Comm'r, 95 T.C.M. (CCH) 1277 (2008).

[67] *See Kimbell v. United States*, 371 F.3d 257, 268 (5th Cir. 2004), *vacating* 244 F. Supp. 2d 700 (N.D. Tex. 2003); *Mirowski*, 95 T.C.M. (CCH) 1277.

[68] *See Kimbell*, 371 F.3d 257.

[69] *See id.*; *Mirowski*, T.C.M. (CCH) 1277; *Schutt*, T.C.M. (CCH) 1353.

[70] *See Schutt*, T.C.M. (CCH) 1353.

disagreements,[71] investment education for the family and the family's children and grandchildren,[72] providing for children equally,[73] reducing family members' probate costs,[74] and consolidating fractional interests in family assets.[75]

The Obama administration has proposed measures to eliminate family entity non-marketability[76] discounts, but thus far none has been enacted into law. The focus of the budget proposals is to diminish the use of marketability discounts in family entities by creating "a more robust version of section 2704(b)."[77] However, these proposals do not address the elimination of minority discounts.[78] Also, by leaving many of the specific

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[71] *See Kimbell*, 371 F.3d 257; Stone v. Comm'r, T.C.M. 2003-309.

[72] *See Kimbell*, 371 F.3d 257.

[73] *See Mirowski,* T.C.M. (CCH) 2008-74.

[74] *See Kimbell,* 371 F.3d 257.

[75] *Id.*

[76] The Obama administration's Budget Proposals from 2010 through 2013 included the following proposed change to §2704(b), although those proposals have not yet been enacted into law:

> The proposal modifies section 2704(b) to create a category of 'disregarded restrictions' that would be ignored when valuing an interest in a family-controlled entity transferred to a member of the family if, after the transfer, the restriction will lapse or may be removed by the transferor and/or the transferor's family. . . . The proposal provides that disregarded restrictions would include limitations on a holder's right to liquidate that holder's interest in the family-controlled entity that are more restrictive than a standard to be specified in regulations. A disregarded restriction also would include a limitation on a transferee's ability to be admitted as a full partner or holder of an equity interest in the entity. . . . Such interests are to be identified in regulations. Under the proposal, regulatory authority is granted, including the ability to create safe harbors under which the governing documents of a family-controlled entity could be drafted so as to avoid the application of section 2704 if certain standards are met.

See STAFF ON JOINT COMM. ON TAX'N, 111TH CONG., DESCRIPTION OF REVENUE PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 2010 BUDGET PROPOSAL—PART ONE: INDIVIDUAL INCOME TAX AND ESTATE AND GIFT TAX PROVISIONS, at 140-42 (Joint Comm. Print 2009), *available at* https://www.jct.gov/publications.html?func=startdown&id=3573 [hereinafter 2010 Budget Proposal]. The budget proposal indicates that the Administration wants to reduce non-marketability discounts in family entities, but it leaves to the Treasury the specific areas of abuse that need to be remedied. However, the proposal indicates that whatever restrictions are to be disregarded would apply retroactively to October 8, 1990 (the effective date of section 2704). Dept. of the Treas., General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals, at 121 (May 2009); Dept. of the Treas., General Explanations of the Administrations Fiscal Year 2011 Revenue Proposals, at 124 (Feb. 2010), *available at* http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2011.pdf; Dept. of the Treas., General Explanations of the Administrations Fiscal Year 2012 Revenue Proposals 127 (Feb. 2011), *available at* http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2012.pdf; Dept. of the Treas., General Explanations of the Administrations Fiscal Year 2013 Revenue Proposals 260, at 268 (Feb. 2012), *available at* http://www.treasury.gov/resource-center/tax-policy/documents/general-explanations-fy2013.pdf ("The proposal was contained in the President's budget proposals for fiscal years 2010, 2011, and 2012."). *See* Ronald D. Aucutt, The Obama Administration's Revenue Proposals, Capital Letter No. 17 (Sep. 30, 2009), *available at* http://www.actec.org/public/capitalletter17.asp ("The proposal is estimated to raise revenue by $19.038 billion over the ten fiscal years from 2010 through 2019. The estimate of $667 million of additional revenue for fiscal 2010, which ends September 30, 2010, necessarily assumes that enactment will occur early enough to catch a substantial number of transfers in calendar 2009.").

[77] 2010 Budget Proposal, *supra* note 76, at 142.

[78] 2010 Budget Proposal, *supra* note 76, at 144 ("Although the Administration's budget proposal considers family relationships in determining whether a restriction on liquidation could be removed for purposes of section 2704(b), it does not include a family attribution rule that addresses the inappropriate use of minority discounts where family members control an entity. Some may argue, however, that such a family attribution rule would be inappropriate, because it is not correct to assume that individuals always will cooperate with one another merely because they are related."); *see* Paul L. Caron & James R. Repetti, *Revitalizing the Estate Tax: 5 Easy Pieces,* 142 Tax Notes 1231, 1232-34 (Mar. 17, 2014) *available at* http://

"disregarded restrictions" to the Treasury to define in regulations, the proposals are inherently vague. However, the Administration's revenue estimates, in the context of transfer taxation,[79] are significant.[80]

The simpler gift tax would streamline the transfer tax valuation of most family entities by ignoring the family entity and valuing the underlying assets transferred to those entities. With traditional gift tax precepts, however, the simpler gift tax would exempt family entities that operate businesses as long as the transferred assets are customary in kind and extent to similar non-family operating business entities.[81] There would be no motive inquiry,[82] just the economic equivalence test in, and the ordinary-course-of-business exception of, current gift tax law. With the goal of simplifying the transfer tax system, these changes may be more politically palatable.

III. GIFT COMPLETION RULES

Under current law, the rules for gift completion are found in Regulation § 25.2511-2. They begin with a clear focus: the central tenet of gift completion is the donor's relinquishment of the transferred property, regardless of whether the donee's identity is known.[83] A donor makes a completed gift when he "has so parted with dominion and control as to leave in him no power to change its disposition, whether for his own benefit or for the benefit of another . . . ."[84] The regulation should have stopped

papers.ssrn.com/sol3/papers.cfm?abstract_id=2410985 [hereinafter Carson & Repetti] (proposing to eliminate minority discounts when the transferred entity or asset continues to be controlled by the transferor or certain family members).

[79] Revenue collected from federal transfer taxes, particularly from gift taxes, is very low as compared to revenue derived from the federal income tax. *See* JOSEPH A. PECHMAN, FEDERAL TAX POLICY 222 (3d ed. 1977) ("Despite the appeal of estate and gift taxes on social, moral, and economic grounds, taxes on property transfers have never provided significant revenues in this country."). Even with the preferences for gifts, taxpayers generally do not fully take advantage of them. *See id.* at 231-32 ("The figures . . . show clearly that wealthy people prefer to retain the bulk of their property until death and fail to use gifts to maximum tax-saving advantage. There are a number of reasons for the small proportion of gifts. First, most people are reluctant to contemplate death. Uncertainty regarding time of death encourages delay in making estate plans even by those with considerable wealth. Second, many wish to retain control over their businesses. Disposal of stock or real estate frequently means loss of control over substantial enterprises. Third, donors may wish to delay transfers of property until their children have had an opportunity to make their own careers. Fourth, many people—even those who are wealthy—do not know the law and often do not take the advice of their tax lawyers on such personal matters.").

[80] From the elimination of minority discounts, the Administration's estimate is $18.1 billion over the next ten years. SEE JANE G. GRAVELLE, CONG. RESEARCH SERV., R42959, THE ESTATE AND GIFT TAX PROVISIONS OF THE AMERICAN TAXPAYER RELIEF ACT OF 2012, at 6 (2013) (discussing the Administration's FLP proposal within the Minority Discounts section), *available at* https://www.fas.org/sgp/crs/misc/R42959.pdf.

[81] *See* Caron & Repetti, *supra* note 78, at 1234 (rejecting a family business exception to their proposal).

[82] That is, there would be no motive inquiry except to the extent that the regulations define the ordinary course of business exception as being "free from any donative intent." *See* Treas. Reg. §25.2512-8.

[83] Treas. Reg. § 25.2511-2(a).

[84] Treas. Reg. § 25.2511-2(b). A purely administrative power subject to fiduciary restraints is not considered a retained power either under current transfer tax rules or under the proposed simpler gift tax. *See* Casner, *supra* note 28, at 547 ("[A] problem is presented as to whether certain administrative powers are to be regarded as powers to determine who takes under the transfer. Even if broadly stated, basically administrative powers should not be so regarded, if under the controlling local law the trustee is subject to fiduciary standards in their exercise.").

there. The rest of the regulation contains double negatives,[85] convoluted syntax,[86] and is generally confusing.[87]

More significantly, the remainder of the regulation parses unsatisfying distinctions and creates inconsistency with the estate tax provisions covering identical types of transfers. For example, it makes sense that if the donor retains the power to name new beneficiaries, the gift is not complete; however, it is unclear why the regulation does not view the donor's retained power over the timing of the donee's receipt of the gift in the same light.[88] Why is the retained control over timing insufficient to negate the transfer of the donor's control? If, as donee, I may have to wait fifty years or more to receive the property (although I may receive it earlier at the donor's whim), how has the donor relinquished sufficient control over the property to indicate she has surrendered ownership of the property? Under the estate tax provisions, if one retains control over the timing of beneficial enjoyment of transferred property, the property is thereby in the donor's estate.[89] Thus, the conflict with the estate tax rules indicates she has *not* transferred such ownership.

Likewise, the gift tax rule for joint retained control under the regulation[90] effectuates a completed gift that, under the estate tax rules, is subject to estate tax inclusion.[91] The gift tax rule concerning the donor's retention of a power jointly with another requires that the other power holder be someone who has a "substantial adverse interest"[92] to the donor's exercise of her power in order for the gift to be complete. The rationale is that self-interest will make the joint power holder reluctant to allow the donor to exercise her power,[93] but the estate tax rule requires estate tax inclusion if the donor retains at her death a power jointly with anyone. While the gift tax motivation-based principle may or may not be appropriate (since the wealthy donor likely has more power

[85] *See, e.g.,* Treas. Reg. § 25.2511-2(d) ("A gift is *not* considered *incomplete*. . . ." (emphasis added)).

[86] *See, e.g.,* Treas. Reg. § 25.2511-2(c) ("Thus, if an estate for life is transferred but, by an exercise of a power, the estate may be terminated or cut down by the donor to one of less value, and without restriction upon the extent to which the estate may be so cut down, the transfer constitutes an incomplete gift.").

[87] Treas. Reg. § 25.2511-2(b) ("For example, if a donor transfers property to another in trust to pay the income to the donor or accumulate it in the discretion of the trustee, and the donor retains a testamentary power to appoint the remainder among his descendants, no portion of the transfer is a completed gift. On the other hand, if the donor had not retained the testamentary power of appointment, but instead provided that the remainder should go to X or his heirs, the entire transfer would be a completed gift. However, if the exercise of the trustee's power in favor of the grantor is limited by a fixed or ascertainable standard . . . , enforceable by or on behalf of the grantor, then the gift is incomplete to the extent of the ascertainable value of any rights thus retained by the grantor.").

[88] *See* Treas. Reg. § 25.2511-2(c) (retained power to add a new beneficiary); Treas. Reg. § 25.2511-2(d) (retained power to affect timing of beneficial enjoyment).

[89] *See Lober v. United States*, 346 U.S. 335 (1953).

[90] Treas. Reg. § 25.2511-2(e) provides that "[a] donor is considered as himself having a power if it is exercisable by him in conjunction with any person not having a substantial adverse interest in the disposition of the transferred property or the income therefrom."

[91] *See Camp v. Comm'r,* 195 F.2d 999 (1st Cir. 1952).

[92] As defined in the income tax grantor provisions, a "substantial adverse interest" refers to a beneficiary's economic interest in the trust that would make him unlikely to join in on a decision to diminish his own financial interest. Treas. Reg. § 1.672(a)-1(a) (1960); *see e.g.*, Treas. Reg. § 1.672(a)-1(b) ("Thus, if A, B, C, and D are equal income beneficiaries of a trust and the grantor can revoke with A's consent, the grantor is treated as the owner of a portion which represents three-fourths of the trust; and items of income, deduction, and credit attributable to that portion are included in determining the tax of the grantor.").

[93] *See Camp*, 195 F.2d at 1004-05.

to control lifetime decisions over the exercise of a joint power), the estate tax rule is a much simpler rule. Therefore, the simpler gift tax would allow the gift tax rule to conform to estate tax law.

Under the current gift tax rules, a gift of a contingent interest to third parties is a completed gift,[94] valued to reflect the risk of loss,[95] and not subject to estate tax. However, if § 2702[96] applies to a transfer with a contingent reversionary interest, that interest will have zero value and the undiscounted value of the property is subject to gift tax. By contrast, under the simpler gift tax, if the donor retains any interest in the property, even a contingent interest, it is an incomplete gift of the donor's whole ownership interest.[97] The simpler gift tax is more comprehensible than the present rules

[94] *See Smith v. Shaughnessy*, 318 U.S. 176, 180 (1943) (holding that the gift tax reaches gifts of "property, however conceptual or contingent"); *see also Dickman v. Comm'r*, 465 U.S. 330 (1984). Where gifts are subject to the condition that they will not be subject to gift tax, the condition subsequent is void as contrary to public policy. *See Comm'r v. Proctor*, 142 F.2d 824 (4th Cir. 1944). Gifts subject to the donee's payment of gift tax are net gifts computed by subtracting the gift tax as partial consideration for the gift. *See Diedrich v. Comm'r*, 457 U.S. 191 (1982) (holding that in terms of a net gift, the donor realizes gain where the amount of the gift tax paid exceeds the donor's basis in the property).

[95] *See, e.g., Jewett v. Comm'r*, 455 U.S. 305, 310 n.11 ("As the Tax Court noted in this case: 'The value of petitioner's remainder interest was not, of course, equal to 50 percent of the value of the trust corpus. Rather, it depended upon actuarial factors reflecting the various contingencies.'" (quoting Jewett v. Comm'r, 70 T.C. 430, 435 n.3)).

[96] I.R.C. § 2702 was enacted as part of the Revenue Reconciliation Act of 1990 ("The 1990 Tax Act"). Pub. L. No. 101-508, §§ 11601-02(a), 104 Stat. 1388-400, 1490-91 (1990). (The 1990 Tax Act added §§ 2701–04 (Chapter 14) to the Internal Revenue Code. I.R.C. § 2702 applies to transfers to "a member of the transferor's family" (i.e., the donor's spouse, his (or his spouse's) ancestor or lineal descendant (or their spouses), or his sibling (or his sibling's spouse) where the transferor or "applicable family member" (i.e., the transferor's spouse, his ancestor, or his ancestor's spouse) retains an interest in a trust or in property treated as if held in a trust.). I.R.C. §§ 2702(e)), 2704(c)(2), 2701(e)(2), 2702(c)(1), 2702(a)(3)(ii) (2012); Treas. Reg. § 25.2702-5. For current transfers with retained contingent reversions, the completed gift is generally valued at its full value without any reduction for the possibility that the property could revert to the donor. *See* I.R.C. § 2702 (2012) (providing that unless the retained interest is a "qualified interest," the donor's retained interest will be valued at zero); Treas. Reg. § 25.2702- 3(f)(iii) ("[A]n interest is non-contingent only if it is payable to the beneficiary or the beneficiary's estate in all events."). Where a donor transfers property subject to alternate contingencies that cover all logical possible events or conditions, although she retains a reversionary interest at law, even without the application of I.R.C. § 2702, the donor's retained interest in such a case would be valueless under current gift tax rules.

[97] Let us examine the difference between the following two transfers in terms of donor-retained control: (1) a donor who retains the power to change the relative income interests of two third-party beneficiaries, which under the regulation is not a completed gift because of too much donor-retained control; and (2) a donor who sets different percentage ownership interests in trust income as between two third-party beneficiaries depending on calculations derived by multiple contingencies provided by the donor when the trust was established. We can assume the multiple contingencies are the typical reasons a donor might want to change the percentage ownership between the two third-parties (e.g., marriage, divorce, employment, school, support needs, other assets, illegal activities, etc.). In the first situation, the donor can change interests capriciously, for any reason, or for no reason at all. In the second situation, the donor may only change the parties' percentage ownership for the reasons stated at the time of the transfer. Otherwise, the two transfers are virtually identical. The current gift tax rules treat the two transfers differently and so would the simpler gift tax. These comparisons parallel the questionable differences between a general power of appointment and a special power of appointment. As Professor Griswold stated, "Any power can very easily be made a special power without materially limiting the [holder's] freedom of choice." Erwin N. Griswold, *Powers of Appointment and the Federal Estate Tax*, 52 HARV. L. REV. 929, 957 (1939). See also Joseph M. Dodge, *Redoing the Estate and Gift Taxes Along Easy-to-Value Lines*, 43 TAX L. REV. 241, 325 (1988) ("The definition of general power under current law is unsatisfactory insofar as it exempts a power to withdraw corpus limited by standards relating to 'support,' 'maintenance,' 'health,' and 'education.' In practice, the 'standards' exception has the effect of making the incidence of 2041 elective among the cognoscenti." (citations omitted)).

for gift completion: A donor makes a completed gift when he has so parted with dominion and control as to leave in him no power or interest in the transferred property. The new rule is blunt, uncomplicated, and is consistent with the estate tax rules. Therefore, gift completion only occurs during lifetime with respect to donor retained control or interests if the donor relinquishes all of those powers or interests more than three years before his death.[98]

While adopting a hard-to-complete rule may reduce the number of gifts, 2009 data shows that reduction would be limited. In 2009, almost two-thirds of reported gifts were outright transfers,[99] and approximately half of taxable and nontaxable gifts consisted of cash, which when added to gifts of real estate and stock, totaled more than eighty percent of reported gifts for the year.[100] Any revenue loss, may also be counteracted by the greater understanding of the advantages of gift giving brought about by enacting and publicizing the benefits of the simpler gift tax.

Because § 2702 would be repealed as unnecessary under the simpler gift tax, strategies such as short-term zeroed-out GRATs[101] (and their concomitant revenue loss) would disappear.[102] For a zeroed-out GRAT, the retained annuity is calculated to be valued at the same value or close to the same value, if intending to effect a small gift[103]—as the remainder interest passing to third parties. Generally, only one asset is placed in the GRAT in order to avoid tainting a highly appreciating asset. Finally, the term is short, like the two-year term in *Walton*, in order to reduce the chance that the donor might die during the term. Should death occur, the estate tax provisions would tax the full date-of-death value of the trust, and the donor would lose all of the tax benefits associated with the GRAT strategy; therefore, a short period of risk is desirable. By employing this planning device, if the trust asset appreciates more than the calculated actuarial value, any excess value passes to the third parties free of transfer tax (i.e., the extra value would not be reached by either the gift or the estate tax — the latter effect occurring because of the benefit of the easy-to-complete gift tax rule of § 2702).

Many scholars have decried the tax avoidance from the use of GRATs.[104] In addition, President Obama's revenue proposals have included GRAT reform.[105]

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[98] For relinquishments within three years of the donor's death, I.R.C. § 2035 would apply to include those transfers in decedent's estate. *Id.* § 2035 (2012).

[99] Melissa J. Belvedere, *2009 Gifts*, STATISTICS OF INCOME BULL. 143 (Spring 2012) ("Most [2009] gifts (67.3 percent, or $25.5 billion) were given directly, meaning that recipients immediately had full use and enjoyment of the gifts. Gifts through trust, where the donee's use of the gift is controlled by a trustee, accounted for the remaining 32.7 percent ($12.4 billion) of the gifts." (internal reference omitted)).

[100] *Id.* ("Most gifts were in the form of cash which represented 47.5 percent ($18 billion) of total gifts. Cash represented the largest share of gift amounts reported on both taxable and nontaxable returns. Gifts of real estate and stock made up the second and third largest shares of total gifts, 18.4 percent and 16.2 percent of the total, respectively." (internal reference omitted)).

[101] This technique was at least tacitly approved by the Tax Court in Walton v. Commissioner, 115 T.C. 589 (2000), and acquiesced to by the government in Notice 2003-72, 2003-2 C.B. 964. *See* discussion, *supra* note 15.

[102] Qualified Personal Residence Trusts ("QPRTs") would likewise be useless under the simpler gift tax. And, even though this article does not discuss the transfer tax or income tax charitable deduction, CLATs, NIOCRUTs, and NIMCRUTs could also be eliminated if rules similar to the simpler gift tax applied with equal force to charitable gifts.

[103] Some estate planners recommend creating a small taxable gift so that the statute of limitations period would begin to run on the transfer. *See* DODGE, GERZOG & CRAWFORD, *supra* note 15, at 452 n.83.

[104] *See, e.g.*, Caron & Repetti, *supra* note 78, at 1240 (proposing a lifetime limit on GRATs); Gans & Soled, *supra* note 41 at 789–90 (proposing to treat GRATs and QPRTs as incomplete gifts until the

Specifically, the Administration's proposal mandates a minimum ten-year term for a GRAT. That would increase the risk of § 2036 exposure, which, if the donor died within the lengthened trust term, would subject the trust property to estate tax.[106] This measure would eliminate the *Walton* short-term (two-year) zeroed-out GRAT and would increase the chance of that device creating an estate tax transfer rather than a preferred gift tax transfer—effectively imposing a hard-to-complete rule. The President's GRAT proposal was estimated to increase revenue by $3.6 billion over a ten-year period.[107]

Finally, the simpler gift tax would eliminate the current freebie known as the five or five power rule under § 2514(e).[108] Section 2514(e) exempts from gift tax[109] a lapse (as distinct from an exercise or release) of the power[110] in stating that a lapse will not be considered a release, which would cause the property to be subject to gift tax[111] to the extent that the value of the property subject to the donee holder's general power to withdraw funds from the trust does not exceed the greater of $5,000 or five percent of the aggregate value of the property subject to the power. That is, in each year the donee power holder allows his power over the statutorily *de minimis* amount of property to lapse, he would not be making a gift of future interest to the remainder beneficiary of the trust.[112] Although he is a donee because he did not create the trust for his benefit, he is

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grantor's interest terminates or, at the taxpayer's option, to tax the full value of the property paid to the trust (instead of only the remainder value)).

[105] The Joint Committee on Taxation proposed imposing a minimum ten-year term requirement for a GRAT. STAFF OF JOINT COMM. ON TAX'N, 111th Cong., DESCRIPTION OF REVENUE PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 2010 BUDGET PROPOSAL—PART ONE: INDIVIDUAL INCOME TAX AND ESTATE AND GIFT TAX PROVISIONS 149 (Joint Comm. Print 2009).

[106] I.R.C. § 2036(a) provides as follows:

> The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death -- (1) the possession or enjoyment of, or the right to the income from, the property, or (2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.

[107] *See* GRAVELLE, *supra* note 80, at 6.

[108] I.R.C. § 2514(e) was enacted in 1951. *See* Powers of Appointment Act of 1951, Pub. L. No. 82-58, 65 Stat. 91 (1951), *reprinted in* 1951-2 C.B. 343. This Code section provides as follows:

> The lapse of a power of appointment created after October 21, 1942, during the life of the individual possessing the power shall be considered a release of such power. The rule of the preceding sentence shall apply with respect to the lapse of powers during any calendar year only to the extent that the property which could have been appointed by exercise of such lapsed powers exceeds in value the greater of the following amounts: (1) $5,000, or (2) 5 percent of the aggregate value of the assets out of which, or the proceeds of which, the exercise of the lapsed powers could be satisfied.

[109] I.R.C. § 2041(b)(2) provides the same exemption from estate taxation. I.R.C. § 2041(b)(2) (2012).

[110] Essentially, a lapse requires inaction. For an explanation of the interplay between a five or five power and the annual exclusion, including a discussion of a "hanging power," see DODGE, GERZOG & CRAWFORD, *supra* note 15, at 135–36.

[111] Additionally, the estate tax equivalent provision prevents inclusion in the donee power holder's estate. *See* I.R.C. § 2041(a)(2).

[112] Moreover, the donee power holder could continue to receive the income from that amount and not have any property included in his estate under I.R.C. § 2041(a)(2), which parallels §§ 2035–38 for general power of appointment holders. *See* I.R.C. §§ 2035–2038, 2041(a)(2). Without a lapse instead of an exercise or release, inclusion in decedent's gross estate is determined under Treas. Reg. § 20.2041-3(d)(3)-(5). *See* Treas. Reg. § 20.2041-3(d)(3)–(5).

also rendered a donor by not taking money out of the trust as he is able to do by exercising his withdrawal power; by leaving the money in the trust, he becomes a donor to the remainder beneficiary who receives those additional amounts. Estate planners typically restrict the time for exercising the five or five power to ensure that it is likely to "lapse." As is readily apparent, this Code provision and related computations are complex.

Although use of this *de minimis* exclusion is very common today in estate planning,[113] it does not serve any valid purpose[114] and is inconsistent with fundamental transfer tax rules. In enacting this gift and estate tax exemption, Congress codified the then common practice of allowing a beneficiary to withdraw small sums so long as he did not make such a withdrawal on the rationale that other income beneficiaries were "unsophisticated" and needed such a fallback provision.[115] However, as a representative from the American Bar Association ("ABA") countered:

> [D]onees in small communities or with general powers over small funds, who did not have access to competent legal advice, either might not learn of the existence or nature of their powers or might not be properly advised of steps which could be taken to reduce their estate tax liability.[116]

In 1988, the ABA urged repeal of this exemption.[117]

Essentially, because of its complexity and lack of a defensible policy rationale, the power of appointment five or five exception would not be included in the simpler gift tax.

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[113] The popularity of the combination of providing for both a five or five power and a *Crummey* annual exclusion withdrawal power is clear. *See, e.g.*, ABA Sec. of Tax'n Task Force on Transfer Tax Restructuring, *Report on Transfer Tax Restructuring*, 41 TAX LAW. 395, 412 (1988) [hereinafter ABA Sec. of Tax'n Task Force] ("This 'five-and-five' exception and the resulting *Crummey* problem discussed above may be routinely exploited by some sophisticated taxpayers.").

[114] *See* George Craven, *Powers of Appointment Act of 1951*, 65 HARV. L. REV. 55, 78 (1951). It appears that the provision was merely enacted to reflect current trust provision practice: "Prior to the 1942 Act it was quite common for a testator in his will to give a noncumulative power of invasion of principal in a small amount each year to his widow or children, and it is quite likely that this practice will be revived." *Id.* At the time of this rule's enactment, it was unclear how popular this devise would become: "It is too early to know just what use will be made of the provisions which exempt the first $5,000 or 5% of a trust fund over which a power lapses during the lifetime of the donee." *Id.*

[115] *See* S. COMM. ON FIN., S. REP. NO. 82-382, at 5 (1951), *reprinted in* U.S.C.C.A.N. (1951 Stat.) 1530, 1535–36 ("Since the problem of the termination or lapse of powers of appointment during life arises primarily in the case of dispositions of moderate-sized properties where the donor is afraid the income will be insufficient for the income beneficiary and therefore gives the income beneficiary a noncumulative invasion power, it is believed that the exemption provided in the committee amendment ($5,000 or 5 percent of the principal) will be adequate to cover the usual cases without being subject to possible abuse."). *See also* Craven, *supra* note 114, at 77. In fact, however, this provision has been of greater service to sophisticated taxpayers who do hire attorneys to avoid wealth transfer taxes. *See* ABA Sec. of Tax'n Task Force, *supra* note 113.

[116] Craven, *supra* note 114, at 63.

[117] *See* ABA Sec. of Tax'n Task Force, *supra* note 113, at 412 ("There is no conceptual justification for that exception."); Amy Morris Hess, *The Federal Taxation of Nongeneral Powers of Appointment*, 52 TENN. L. REV. 395, 429 (1985) (arguing that the five or five power exception is "simply an obvious example of the propensity of Congress to draft transfer tax statutes that exclude from taxation the most common forms of wealth transmission and tax only the unusual ones.").

IV. TAX PREFERENCES FOR CURRENT LIFETIME GIFTS

Subsequent to unification by the 1976 Tax Act,[118] there remain six benefits to making gifts: (1) the *de minimis* and consumption exclusions under section 2503;[119] (2) the non-taxation of the funds used to pay the gift tax (its "tax-exclusive" base);[120] (3) gift-splitting;[121] (4) the ability to freeze the value of a gift early in the taxpayer's lifetime so that post-gift excess appreciation (increased future value that outpaces inflation) is not taxed;[122] (5) the ability to transfer post-gift income to a lower bracket donee, often rendering the gift partly or wholly exempt from gift tax;[123] and (6) the ability to make non-taxable additional gifts by creating an Intentionally Defective Grantor Trust ("IDGT"),[124] through which the grantor can make a completed gift of the trust property, but continue to pay the income tax liability on the donee's post-gift income, without incurring any additional gift tax.

Rationales for gift tax preferences include: (1) the ability to generate current revenue;[125] (2) the creation of discounts to equalize gratuitous transfers made at different times in the taxpayer's life;[126] (3) gifts, more than bequests, contribute to a decline in wealth concentration;[127] (4) pragmatic reasons;[128] and (5) gifts place property in the hands

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[118] Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520 (1976).

[119] I.R.C. § 2503(b), (e).

[120] *See* discussion, *supra* note 48.

[121] I.R.C. § 2513.

[122] George Cooper, *A Voluntary Tax? New Perspectives on Sophisticated Estate Tax Avoidance*, 77 COLUM. L. REV. 161, 243 (1977) [hereinafter Cooper] ("The ALI report does not grapple with these questions because it proceeds from the convenient assumption that they are not really very important once the estate and gift tax is unified with a single rate scale. . . . More significantly, [the ALI report] brushes aside estate freezing as if it were not even an issue. . . . [T]he easy-to-complete-gift approach is disturbingly inadequate."). However, from an income tax perspective, see Dodge Deemed Realization, *supra* note 1 at 463-64 ("The government's interest under either a carryover-basis or a deemed-realization system would favor an easy-to-complete rule, so as to reduce the pool of property qualifying for upward basis adjustments.").

[123] A gift would not be subject to gift tax, for example, if the value of the gift fell below the credit equivalent amount or the annual exclusion amount. Otherwise, any income tax advantage would be diminished or supplanted by the gift tax disadvantage. That is, the gift tax is generally viewed as preventing wide-scale income shifting. *See* William C. Brown, *Judicial Expansion of the Future Interest Exception to the Gift Tax Annual Exclusion—Examination of the Legislative History and Policy Basis for the Future Interest Exception,* 65 TAX LAW. 477, 481 (2012) [hereinafter Brown] (The gift tax "also serves to discourage income shifting from high bracket taxpayers to low bracket taxpayers under the progressive rate structure of the federal income tax.").

[124] An IDGT avoids additional gifts where the donor makes a gift in trust that is a completed gift for gift tax purposes, but under the grantor trust rules (I.R.C. §§ 671-77) she is still liable for paying income taxes on the trust income. *See* Daniel L. Ricks, *I Dig It, But Congress Shouldn't Let Me: Closing the IDGT Loophole*, 36 ACTEC L. J. 641 (2010).

[125] *See* Cooper, *Ghosts of 1932*, *supra* note 21; David Joulfaian, *Gift Taxes and Lifetime Transfers: Time Series Evidence,* 88 J. Pub. Econ. 1917, 1919 (2004) [hereinafter Joulfaian].

[126] *See* Joulfaian, *supra* note 125, at 1919 ("The benefit to the wealthy from such acceleration is that paying the gift tax would be equivalent to prepaying the estate tax, but at a significant discount."); *See* Jerome Kurtz & Stanley S. Surrey, *Reform of Death and Gift Taxes: The 1969 Treasury Proposal, the Criticisms, and a Rebuttal,* 70 COLUM. L. REV. 1365, 1390-391 (1970) [hereinafter Kurtz & Surrey] ("The only way to provide for an equitable encouragement of gifts is to adopt a unified transfer tax system with gross-up for lifetime transfers and then allow some percentage discount in the rate applicable to gifts as compared to death transfers.").

[127] PECHMAN, *supra* note 79, at 233 ("It is argued, in fact, that gifts tend to reduce the concentration of wealth by dispersing property among a relatively large number of donees.").

[128] *See* 1 Dept. of Treasury, Tax Reform for Fairness Simplicity and Economic Growth, 376 (Nov. 1984) [hereinafter Tax Reform for Fairness Simplicity] ("Notwithstanding the policies supporting full

of the young who invest in riskier holdings.[129] Reasons to eliminate these preferences include: (1) the further unification of gift and estate taxes;[130] (2) gift tax preferences unfairly favor the richest donors who are less likely to require all of their property to satisfy their future needs;[131] (3) the government should not interfere with the timing of family wealth transfers,[132] and (4) the argument that transfers to younger generations encourage more diversified investments is unsupported and inaccurate, particularly for gifts made in trust.[133]

The Treasury's 1984 Tax Reform Proposals included a proposal to further unify the gift and estate taxes: the gift tax, like the estate tax, would be a tax inclusive tax; that is, funds that are used to pay the gift tax would, as with estate tax and income tax,

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unification of the estate and gift taxes, significant tax incentives remain for individuals to make lifetime gifts. Arguably, some of these tax advantages are justifiable because of practical considerations. For example, the $10,000 annual exclusion from gift tax is often justified as a threshold for application of the tax because of the compliance and administrative problems that otherwise would be created. The application of the same progressive rate schedule to all transfers, without adjustment for post-transfer appreciation in the value of the property, may also be justified because of simplicity and because a lifetime transfer deprives the donor of the use of the property and the use of any money used to pay gift tax on the transfer.").

[129] *See* Kurtz & Surrey, note 126 *supra*, at 1390 ("The argument usually advanced to support tax incentives for lifetime gifts is that it is to the advantage of the government to have property moved into younger hands, for the young will tend to be more venturesome with such capital and thus improve the economic climate by increasing the mobility and risk-taking capacity of that capital."); *see also* note 133, *infra*.

[130] *See* Tax Reform for Fairness Simplicity, *supra* note 128, at 145 (Nov. 1984) ("Perhaps the most significant of these proposals is to complete the unification of the estate and gift tax systems by conforming the computation of the gift tax base to that of the estate tax. . . . Together, these changes will assure that the form of ownership and transfer of assets within a family will play a greatly reduced role in determining the transfer taxes paid by that family."). The 1976 Tax Act unified the gift and estate tax rates and exemptions and made gifts and bequests part of the same cumulative rate structure for estate tax purposes. *See* DODGE, GERZOG & CRAWFORD, *supra* note 15, at 42-43, 449; SURREY, *supra* note 21, at 56. But, some preferences for gifts remain. PECHMAN, *supra* note 79, at 231 (citing the gift tax annual exclusion and the tax exclusive tax base).

[131] *See* Tax Reform for Fairness Simplicity, *supra* note 129, at 374 ("In addition, since wealthier individuals are more likely to be financially able to make substantial lifetime gifts, taxing lifetime transfers and transfers made at death in the same manner helps to ensure fairness and progressivity in the overall transfer tax system."); Kurtz & Surrey, *supra* note 126, at 1371 ("But even assuming that some favoritism [for lifetime gifts] should be shown, the existing system provides this favoritism in an irrational and inequitable manner. . . .the larger the estate, the more advantageous transfer by gift becomes."); PECHMAN, *supra* note 79, at 232 ("And among those who do make gifts, the law discriminates in favor of wealthier donors by rewarding them with larger tax savings than less wealthy donors obtain on gifts of the same value. This feature stems from the exclusion of the gift tax from the base of the tax.").

[132] *See* Tax Reform for Fairness Simplicity, *supra* note 129, at 374 ("Unification of the gift and estate taxes is designed to ensure that taxes are a relatively neutral factor in an individual's decision whether to make a lifetime gift."); Kurtz & Surrey, *supra* note 126, at 1390 ("[T]he Government is not appropriately concerned with the rate of transfer of wealth from parents to children and should leave such matters to family decision, or at least it is not so concerned as to provide tax incentives to affect whatever may be a family's natural inclinations in such matters.").

[133] *See* SURREY, *supra* note 21, at 273 ("If the purpose is to move property into younger and presumably more venturesome hands, in a desire to produce economic benefits by supposedly increasing the mobility and risk-taking capacity of capital, analysis is then required as to whether this result in fact occurs. If the gifts are in trust then the economic effect is not likely to differ from continued ownership by the donor."); Kurtz & Surrey, *supra* 126, at 1391 ("Most lifetime gifts are of marketable securities placed in trust, and they are made at a time when the donor is quite elderly. A gift to a trust extending for a long period of time seems little different in terms of economic mobility and risk-taking than continued ownership by the donor.").

themselves be subject to tax.[134] As with estate tax and income tax, the additional grossed-up tax would be built into the gift tax tables, which the taxpayer could easily access.[135] According to the Treasury Department, with this additional unity between the transfer taxes, certain tax provisions could be repealed[136] and gift completion rules could be simplified.[137] Under the proposed 1984 rules, retained powers would be ignored to allow for an easy-to-complete rule of gift completion;[138] retained interests would be ignored for valuation purposes, but a retained interest gift would be considered complete at the expiration of the retained interest.[139] The retained interest rule would decrease dependence on actuarial tables and would produce more accurate valuation.[140]

However, the 1984 proposal also presents serious problems by ignoring retained powers and using easy-to-complete rules. Complex retained power transfers would proliferate (contrary to the proposal's stated goal of simplification) because the wealthy generally care more about retaining power over transferred assets as compared to retaining an interest in the transferred property.[141] Moreover, under the proposal, post-transfer growth, which may be substantial, would pass to third parties without being subject to transfer taxes. Some of the most significant anti-abuse provisions, such as sections 2036(a)(2) and 2038, which require date of death value estate tax inclusion for lifetime transfers with retained powers, would be eliminated. Though the 1984 proposal states that an adjustment of the gift for post-transfer appreciation is unwarranted "because a lifetime transfer deprives the donor of the use of the property and the use of any money used to pay gift tax on the transfer,"[142] that rationale falls short when one considers that

[134] *See* Tax Reform for Fairness Simplicity, *supra* note 129, at 377-78 ("Application of the gift tax on a tax-inclusive basis would eliminate the major disparity between the transfer tax treatment of lifetime gifts and transfers at death.").

[135] *See* Tax Reform for Fairness Simplicity, *supra* note 129, at 377.

[136] Primarily, I.R.C. § 2035(a), the section that deals with gifts of life insurance and transfers of "taxable strings" within three years of decedent's death, would be repealed. The same is true for I.R.C. § 2035(b), which "grosses up" the decedent's estate by adding the gift tax paid as an estate tax inclusion. Repealing I.R.C. § 2035(b) makes sense as that provision is duplicative of the main 1984 unification proposal. *Inter vivos* charitable Lead Trusts ("CLTs"), which, under current law, are subject to abuse, would be reformed under the 1984 proposal. "The creator of such a trust would be treated as owning the property for transfer tax purposes until the vesting of the non-charitable interest or his or her death, if sooner.": that would mean that the donor's third party remainder gift would be accurately valued at the time that interest vests. *Id.* at 379.

[137] *See* Tax Reform for Fairness Simplicity, *supra* note 129, at 378-83 ("Finally, by removing the major incentive for disguising testamentary transfers as lifetime gifts, the proposal would permit the simplification of the rules governing when a transfer is complete for estate and gift tax purposes.").

[138] *Id.* at 379.

[139] *Id.* at 380.

[140] *Id.* at 382 ("By delaying the imposition of transfer tax liability until the donor's interest terminates, the proposed rules would reduce the number of instances in which it is necessary to consult an actuarial table to value the transfer of a partial interest in property and would provide greater accuracy in the valuation of the transferred interest.").

[141] *See* RICHARD SCHMALBECK, AVOIDING FEDERAL WEALTH TRANSFER TAXES, RETHINKING ESTATE AND GIFT TAXATION, 121-22 (William G. Gale, James R. Hines, Jr. & Joel Slemrod eds., 2001) (concluding that even with the great tax benefit of the annual exclusion, few wealthy taxpayers currently are influenced to make those lifetime transfers because "the real barrier to full use of the annual exclusion is the strong preference of potential donors for the retention of economic power.").

[142] *See* text note 128, *supra*.

abusive transfer tax freeze strategies would likely become even more popular estate planning devices.[143]

The stated policy of the 1932 annual exclusion was two fold: on one hand, "to obviate the necessity of keeping an account of and reporting numerous small gifts and on the other, to fix the amount sufficiently large to cover in most cases wedding and Christmas gifts and occasional gifts of relatively small amounts."[144] That stated policy, which highlights the exclusion's administrative goal,[145] was intertwined with the overriding purpose of the gift tax, to raise immediate revenue during the Depression years.[146] Otherwise, the 1932 $5,000 exclusion would not have been such a large one, allowing relatively large gifts to go untaxed.[147] In fact, together with the other gift tax preferences[148] enacted with the 1932 Act,[149] the large annual exclusion successfully encouraged taxable gifts. According to economists, 1935 produced the second largest revenue from gift taxes when indexed for inflation.[150]

Scholars have criticized the annual exclusion, particularly the "present interest" requirement, and many have urged the elimination of *Crummey* powers,[151] but this author proposes to have the annual exclusion return to its original *stated* purpose of eliminating the need to keep track of minor gifts, which do not substantially add to the donee's wealth. The simpler gift tax, therefore, includes an annual exclusion for small outright gifts (capped at $2,000, with inflation adjustments, aggregated yearly per donee).[152]

[143] *See* Cooper, *supra* note 122, at 247 ("For the time being, there are a number of steps which have been described above that can reasonably be taken to improve the estate and gift tax. Those measures, in particular the modifications in valuation procedures to stop the absurd abuses now occurring, will do much to protect the tax base and improve the fairness and effectiveness of the tax in reaching existing accumulated wealth. As for estate freezing, some improvements in sections 2036 and 2038 can raise the ante substantially for taxpayers who want to transfer future growth to their prospective heirs, and thereby limit the greatest abuses in this area.").

[144] *See* S. REP. NO. 665, 72D CONG., 1ST SESS. 41, *reprinted in* (1939-1 C. B. (Pt. 2) 525-526; H.R. REP. NO. 708, 72D CONG., 1ST SESS. 29-30, *reprinted in* 1939-1 C. B. (Pt. 2) 478).

[145] *See* Brown, *supra* note 123, at 483 ("The legislative history to the 1932 Act clearly indicates that the principal policy behind the gift tax annual exclusion is administrative in nature--to avoid the necessity of tracking small gifts which do not materially avoid the federal transfer tax system.").

[146] *See* Cooper, Ghosts of 1932, *supra* note 21.

[147] As Brown points out: ". . . the $5,000 annual exclusion enacted as part of the 1932 Act was a very significant exclusion amount relative to the size of the specific exemption amount of $50,000 in the gift tax and hence would be expected to generate gifts designed to reduce future estate tax liability." Brown, *supra* note 123, at 486. In addition, he notes that if you analogize those amounts to 2012 numbers, as a ten percent portion of the exemption or to account for inflation, the 1932 $5,000 annual exclusion would amount, respectively, to $500,000 or to approximately $77,000. Brown, *supra* note 123, at 486.

[148] The 1932 Act included lower rates, a separate cumulate rate structure, and a separate exemption amount for gifts than the ones imposed by the estate tax. In addition, as today's gift tax, the 1932 gift tax was computed on a tax exclusive basis.

[149] Revenue Act of 1932, c. 209, 47 Stat. 169.

[150] *See* Joulfaian, *supra* note 125, at 1924-1925.

[151] *See, e.g.*, Brown, *supra* note 123; CRAWFORD, *supra* note 29, at 446 ("[Congress] should eliminate the present interest requirement and in lieu thereof, allow to qualify for the annual exclusion only outright transfers and transfers in trust that meet the requirements of section 2642(c)."); 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, 666 (1987) [hereinafter Sherman] (proposing that a demand right, like in *Crummey*, not constitute a present interest for annual exclusion purposes); SURREY, *supra* note 21, at 695.

[152] *See* CRAWFORD, *supra* note 29, at 444-45 ("*Crummey* trusts are complex instruments that require substantial professional advice; provisions like those above are entirely tax-driven."); Sherman, *supra* note 151, at 590 ("One seldom makes a gift of a future interest without the advice and intervention of an attorney or other professional.").

While the current $10,000 (with inflation adjustments, making the 2015 exclusion cap at $14,000) annual exclusion may seem more palatable to most people, it is clear that most of the annual exclusion is not used for the statute's original stated purpose, but is instead used to transfer tax-free a goodly sum to third parties.[153] While generally disallowing transfers in trust to qualify for the annual exclusion, the simpler gift tax allows a slightly different version of what is currently referred to as a minor trust under section 2503(c): it would extend until the donee turned thirty years of age. At the donee's thirtieth birthday, the trust would terminate and pay out whatever was held in the trust (corpus and accumulated income) to the donee.

In addition to the annual exclusion, the simplified gift tax embraces and extends some consumption transfers from the gift tax. Each of these new provisions will amend section 2503(e) and all of the section 2503(e) exclusions will be prefaced by a statement that these exemptions are intended to cover consumption items and do not apply to any transfer that is in fact an unconsumed gratuitous property transfer. While accepting that these exclusions indirectly aid the recipient by not requiring him to expend his own wealth for expenses and that education creates human capital, the reality is that most of the following consumption exclusions added in the simpler gift tax provisions are not thought of as gifts. The simpler gift tax would add the following exclusions: (1) an expanded education exclusion; (2) a new exclusion for reasonable living expenses of any donee living in the donor's residence; and (3) a new exclusion for certain payments to caretakers, including family members. These exclusions do not directly increase the donee's accumulation of assets and, like a parent's managerial services, they cannot from a pragmatic position be verified; in addition, they may not rise to the level of property transfers that are subject to the gift tax.[154]

The current section 2503(e) exclusion for medical costs paid directly to the provider is geared to the section 213(d) definition of "medical care."[155] Thus, besides doctors' and hospital costs, other medical expenses that are currently excluded under section 2503(e) include: medical insurance,[156] prescription drugs and insulin,[157] transportation,[158] lodging,[159] and some capital expenses.[160] The simpler gift tax exclusion for education costs would be expanded and tied to the definitions of "qualified higher education expenses" in section 529. As such, the exclusion would not only cover tuition, but would also cover required fees, books, supplies, and equipment while attending an

[153] *See, e.g.* CRAWFORD, *supra* note 29, at 444 ("Well-drafted *Crummey* trusts typically limit the withdrawal right to the annual exclusion amount (less $1,000 or so to allow for de minimis outright gifts during the year)."); David Joulfaian & Kathleen McGarry, *Estate and Gift Tax Incentives and Inter Vivos Giving*, 57 NAT'L TAX J. 429, 430 (2004) [hereinafter Joulfaian & McGarry] ("This [annual exclusion] allowance permits a substantial sum to be transferred to heirs free of tax. While yearly amounts may be small, consistent use of this annual exemption can lead to the tax–free transfer of large amounts of wealth.").

[154] They may be less than the annual exclusion amount or they may be either revocable transfers or licenses. *See* Joseph M. Dodge, *Are Gift Demand Loans of Tangible Property Subject to Gift Tax,* 30 VA. L. REV. 181 (2010).

[155] *See* I.R.C. § 2503(e)(2)(B).

[156] I.R.C. § 213(d)(1)(D).

[157] I.R.C. § 213(b) (limitations on deductible medications).

[158] I.R.C. § 213(d)(1)(B).

[159] Meals and lodging expenses are excluded for a required hospital confinement. In addition, I.R.C. § 213(d)(2) covers $50 per person per night of lodging expenses, not lavish or extravagant, while receiving medical care.

[160] Treas. Reg. § 1.213-1(c)(1)(iii) (excluding, among other expenses, the costs of eye glasses, crutches, and certain medically necessary home alterations).

eligible educational institution, and expenses for special needs services for a special needs student.[161] They would also include room and board for students enrolled at least half-time at an eligible educational institution.[162]

Similar to a 1960's ALI exclusion proposal that ignored food, clothing, and living expenses "for any person dependent upon the transferor,"[163] (capped at $3,000 annually),[164] the simpler gift tax would add exclusions for the reasonable living expenses of any donee,[165] regardless of age, living in the same residence as the donor. Most families either ignore the living expense transfers to adult dependents or non-dependents or, without actually calculating their value, view those expenses as not exceeding the annual exclusion. Because they may not be transfers of property interests or are too difficult to monitor, if they are reasonable in amount and not a subterfuge for property wealth transfers, these consumption costs should be excluded under section 2503(e).

The second new consumption exclusion would cover certain payments made to family-member caregivers. The exclusion would allow cash amounts to be transferred to a family or non-family member in exchange for caregiver services provided either to the transferor, the transferor's spouse, or to a dependent living in the household of the transferor. In order to qualify for this exclusion, the taxpayer would be required timely to file the necessary employment forms and to pay applicable income and employment taxes on those payments in a timely manner. The reason for this exclusion is to state simply the circumstances under which a payment to a family or non-family member, reasonable in amount and in consideration for caretaking services, will be presumed conclusively to be exempt from gift taxes regardless of any local law presumptions to the contrary.

V. COMPLIANCE

Few donors report gifts in a timely manner and the scholars who write about the gift tax compliance failure believe that the causes of this problem are a lackadaisical reporting and penalty system.[166] Taxpayers do not worry about filing gift tax returns "because (1) they know their chances of being caught are infinitesimally small and (2) even if they are caught, they are not likely to be penalized."[167]

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[161] I.R.C. § 529(e)(3)(A).

[162] I.R.C. § 529(e)(3)(B); I.R.C. § 25A(b)(3) (defining eligible student).

[163] *See* SURREY, *supra* note 21, at 190.

[164] *See* Casner, *supra* note 28, at 538-539 ("The exclusion of transfers for consumption will eliminate many transfers from gift taxation that are now technically subject to such taxation. It is believed, however, that many of these eliminated transfers are rather widely ignored today in the gift tax area.").

[165] *See* ALI FEDERAL ESTATE AND GIFT TAX PROJECT: MAJOR PROBLEMS IN FEDERAL ESTATE AND GIFT TAXATION AND RECOMMENDATIONS IN REFERENCE THERETO (1968). One of the purposes of the ALI consumption exclusion was "that there be excluded from gift taxation various so-called transfers for consumption, without regard to whether they in fact involved a discharge of a legal obligation to support another and cause the transfer tax law to be applied in the same way in all geographical areas." *Id.*

[166] *See* Jay A. Soled, Paul L. Caron, Charles Davenport, and Richard Schmalbeck, *Rethinking the Penalty for the Failure to File Gift Tax Returns*, 141 TAX NOTES 757 (2013); Gans & Soled, *supra* note 41, at 760-61.

[167] Gans & Soled, *supra* note 41, at 774. As the basis of the poor compliance rate, Professors Gans and Soled cite the lack of third party information returns, the politically untenable use of random audits that would unlikely produce additional revenue, and, historically, the lack of enforcement of gift tax filing requirements. As solutions, they propose third party (donee or trustee) information return filings, which would be especially productive if a transfer is made in trust; establishing a "meaningful penalty system," similar to the current penalty system, but where the penalty computations would not take into account the gift tax exemption (at the time of the article, the gift tax $1 million lifetime amount), delinquent returns would be

Given that there is no imperative to have preferences for lifetime transfers, apart from a limited annual exclusion, this article proposes to retain other gift tax benefits but only for donors who adhere to the filing and payment requirements. Compliance rules in a verifiable gift tax should replicate the portability rules:[168] If you don't properly file a gift tax return and pay your gift tax, you don't obtain the tax benefits that compliant filers receive.

Depending on which benefits are denied delinquent donors, donors should be motivated to comply. Denying the benefit of a tax exclusive transfer tax should increase self-reporting. For greater incentives, new benefits could be added to gifts, such as limiting the unified credit exemption to the 2009 level $3.5 million unified credit,[169] but for the first $1.5 million in taxable gifts, provide a lower rate or an additional run-through regime similar to a pre-1977 gift tax model.[170] Additional gift tax benefits for compliant donors should produce more revenue in line with the goal of the 1932 gift tax.[171]

Historically, instead of utilizing even simple tax minimization techniques to the maximum extent allowable,[172] wealthy taxpayers have reacted to changes in tax rates by accelerating *inter vivos* transfers.[173] That was particularly true in 1976 in anticipation of the new law's elimination of lower gift tax rates and the separate exemption run-through scheme.[174] According to Joulfaian, 1976 was a banner year for gifts before the 1976 Tax Act took effect in 1977, mainly due to the enormous sensitivity to rate changes between those two years.[175] While the revenue effect of a simpler verifiable gift tax is uncertain, the evidence from 1976 suggests a positive revenue effect from changes that would be policy improvements to the current gift tax.

VI. CONCLUSION

The purpose of this article is to propose a simplified verifiable gift tax, to reassert the basic principles of transfer taxes, to encourage simple, outright gifts, and to eliminate some major abuses in the current gift tax regime. To accomplish these goals, the

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subject to a hefty twenty-five percent maximum penalty if they are five or more months late, with interest accruing from the required filing date. *Id.* at 777-78.

[168] *See supra* notes 49-52 and accompanying text.

[169] Recent legislation has returned the unified credit exemption equivalent to 2009 levels. *See, e.g.*, S. 2899, 113TH CONG., 2D SESS. § 2(b)(1) (amending I.R.C.§ 2010(c)(3) by reducing the "basic exclusion amount" exemption to $3.5 million for transfers after December 31, 2014) (proposed by Sen. Bernard Sanders.).

[170] *See supra* notes 130, 148 and accompanying text.

[171] *See* Cooper, *Ghosts of 1932*, *supra* note 21.

[172] *See* Joulfaian & McGarry, *supra* note 153, at 419 ("Overall, we conclude that while taxes are an important consideration in transfer behavior of the rich, their behavior is not universally consistent with a tax minimization strategy.") ("[I]ndividuals fail to exploit fully available avenues of tax avoidance."). *Id.* at 430.

[173] *See* Joulfaian, *supra* note 125, at 1927 ("Using data for gifts made in the years 1933 through 1988, the findings suggest that the wealthy are quite responsive to taxes in the timing of their gifts, particularly in the short run."); STAFF OF JOINT COMM. ON TAX'N, 112TH CONG., MODELING THE FEDERAL REVENUE EFFECTS OF CHANGES IN ESTATE AND GIFT TAXATION 26 (Joint Comm. Print 2012).

[174] *See supra* notes 130, 148 and accompanying text.

[175] *See* Joulfaian, *supra* note 125, at 1924 ("[G]ifts made in 1976, in anticipation of the higher tax rates in 1977, surpass those made in any other year since the enactment of the tax."). One other factor that probably contributed to the number of gifts in that year was that, under the 1976 Act, carryover basis would be extended to bequests with the repeal of I.R.C. § 1014 (date of death (generally "stepped up") basis rule for transfers at death). While later, the repeal of I.R.C. § 1014 was itself retroactively repealed, in 1976 that post-enactment event could not be anticipated. Therefore, some of the increase in gifts in 1976 could be attributed to the fact that the wealthy anticipated the estate tax inclusion benefit was about to disappear, equalizing the capital gains effect between gifts and bequests.

proposed tax would simplify gift completion rules, adopt a hard-to-complete rule of transfer taxation, reduce the annual exclusion while expanding the consumption exclusion, and employ loss of preference inducements to increase gift tax compliance.