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Should We Give Away the Annual Exclusion?

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I. INTRODUCTION

II. THE RELATIONSHIP OF THE FEDERAL TRANSFER TAXES
- A. *The Federal Estate Tax*
  - 1. *Overview*
  - 2. *Major Exceptions*
- B. *The Federal Gift Tax*
  - 1. *1932 to 1977*
  - 2. *1976 Tax Reform Act Changes*
  - 3. *Exceptions to the Application of the Gift Tax*
  - 4. *Important Continuing Advantages of Making Gifts, Including Use of the Annual Exclusion*
    - a. *Removal of Appreciation From the Donor's Estate*
    - b. *Gift Tax Is Calculated on a Tax Exclusive Basis*
    - c. *The Annual Exclusion*
- C. *The Generation-Skipping Transfer Tax*
- D. *A Brief Perspective on the Relationship of the Annual Exclusion to the Federal Transfer Tax System*

III. HISTORY OF THE ANNUAL EXCLUSION, TECHNICAL REQUIREMENTS AND CURRENT USES
- A. *Historical Development*
  - 1. *The Stated Purpose of the Annual Exclusion*
  - 2. *The ERTA Changes*

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B. *Technical Requirements*
   1. *The Impact of the Present Interest Requirement*
   2. *Withdrawal Rights*
   3. *Some Limited Observations on the Consequences of Recognizing That a Withdrawal Right Gives the Withdrawal Right Holder a Present Interest*

C. *Current Uses of the Annual Exclusion*
   1. *Significant Wealth Transfers*
      a. *Direct Gifts*
      b. *Use of Withdrawal Rights and Life Insurance to Leverage the Annual Exclusion*
      c. *Supplemental Gifts*
   2. *Protecting Excessive Support Transfers Made to Persons to Whom a Legal Obligation of Support Exists*
   3. *Protecting Support Type Transfers Made to Persons to Whom the Transferor Has No Obligation of Support*
   4. *Protecting Normal Gifts From Tax and Reporting*
   5. *Summation of Current Uses*

IV. PROBLEMS WITH THE ANNUAL EXCLUSION UNDER ITS PRESENT DESIGN AND GIVEN ITS CURRENT USES
   A. *Makes Avoidance of the Transfer Tax System Easy*
   B. *Vertical Inequity*
   C. *Horizontal Inequity*
   D. *Disrespect for the Law*

V. VARIOUS APPROACHES TO MODIFICATION
   A. *Reasons to Retain and Modify*
   B. *Reviewing the Earlier Proposals*
      1. *The ALI/Ray Model*
      2. *The Gutman Proposal*
      3. *The Report on Transfer Tax Restructuring*
   C. *Consumption Under the Transfer Tax System: A Key to the Analysis and Modification of the Tuition and Medical Care Exclusions*
      1. *Introduction*
      2. *Consumption Viewed Through the Purpose of the Transfer Tax System*
      3. *When Consumption for Another's Benefit Should Be Viewed as a Transfer for Transfer Tax Purposes*
   D. *Liberalizing the Tuition and Medical Care Exclusions*

E. *Modifications of the Annual Exclusion Considered*
   1. *Reducing the Annual Exclusion Per Donee Limitation*
   2. *Limiting the Amount That Can Be Transferred Under the Annual Exclusion in One Year by Any Single Donor*
   3. *Reducing the Annual Exclusion Available Based on the Accumulated Use of Significant Amounts of Annual Exclusion*
   4. *The Present Interest Requirement*
   5. *The Amount of the Annual Exclusion for Married Couples*
   6. *Gift Tax Reporting*

F. *Implementing the Most Effective and Administrable Modifications to Address the Problems of the Current Annual Exclusion*
   1. *Choosing Among the Most Direct Modifications*
   2. *Choosing Among the Less Direct Modifications*
   3. *What These Changes Will Accomplish*

VI. CONCLUSION

APPENDIX: THE STATUTE AS REVISITED

I. INTRODUCTION

United States gift tax law imposes on the transferor a tax at rates of up to fifty percent on property transfers made during the transferor's lifetime for less than full and adequate consideration in money or money's worth.[1] The tax is calculated on the basis of the fair market value of the property transferred, determined as of the time of the gift.[2] The gift tax is a supple-

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1. IRC §§ 2001(c)(2)(D), 2501(a)(1), 2502(a), (c), 2512(b); Regs. § 25.2512-8. Regulations section 25.2512-8 states:

> Transfers reached by the gift tax are not confined to those only which, being without a valuable consideration, accord with the common law concept of gifts but embrace as well sales, exchanges, and other dispositions of property for a consideration to the extent that the value of the property transferred by the donor exceeds the value in money or money's worth of the consideration given therefor. 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. A consideration not reducible to a value in money or money's worth, as love and affection, promise of marriage, etc., is to be wholly disregarded, and the entire value of the property transferred constitutes the amount of the gift.

Regulations section 25.2511-1(g)(1) states:

> Donative intent on the part of the transferor is not an essential element in the application of the gift tax to the transferor. The application of the tax is based on the objective facts of the transfer and circumstances under which it is made, rather than on the subjective motives of the donor. However, there are certain types of transfers to which the tax is not applicable. It is applicable only to a transfer of a beneficial interest in property. It is not applicable to a transfer of bare legal title to a trustee.

These provisions illustrate an important aspect of the federal gift tax provisions, and, indeed, all the related federal transfer taxes, which is: while relevant state law determines the basic property rights of taxpayers (e.g., who is the owner of the beneficial interest in property), federal law determines the tax consequences without regard to the labels imposed by state law. Commissioner v. Bosch, 387 U.S. 456 (1967). Hence, while state law may require that the transferor of property have a donative intent in order for the transfer to be a gift for state law purposes, no such intent is required for there to be a gift for tax law purposes. If, on the other hand, under state law the transferor has not parted with his beneficial interest in the property transferred (for example, when a resulting trust is imposed on the transferee), then no gift tax is imposed on the transfer because the beneficial interest has not been transferred.

2. IRC § 2512(a); Regs. §§ 25.2511-2, 25.2512-1. Regulations section 25.2512-1 adopts a "willing buyer, willing seller" test for valuation. It states:

> Section 2512 provides that if a gift is made in property, its value at the date of the gift shall be considered the amount of the gift. The value of the property is the price at which such property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of

ment to the federal estate tax, which is imposed on transfers of property at death at rates up to fifty percent. If there were no gift tax, the estate tax could be substantially avoided by making lifetime gifts.[3] Neither lifetime gifts nor testamentary bequests of property are subject to income tax in the hands of the transferor or the transferee.[4]

There are several exceptions to the gift tax, one of which is the annual exclusion.[5] The annual exclusion permits an individual to make gifts of up to $10,000 a year to any number of persons without incurring any gift tax.[6] The annual exclusion is available only if the donee is given a present right of possession or enjoyment as to the value with respect to which the exclusion is claimed.[7] As is demonstrated below, the annual exclusion can be used, both directly and indirectly, to permit very large amounts to escape

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relevant facts.

The time that a gift is made is determined under Regulations sections 25.2511-2(a) and (b), which provide in part:

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

3. Richard B. Stephens et. al., Federal Estate and Gift Taxation, ¶ 9.01 (6th ed. 1991); IRC § 2001(a), (c)(2)(A).

The 50% rate applies to taxable transfers in excess of $2,500,000 and was the statutory maximum rate as of the date the writing of this article was completed. IRC § 2001(c)(2)(D). However, President Clinton proposed restoring the maximum rate to 55% on taxable transfers in excess of $3,000,000, which was the maximum rate before 1993. Staff of Joint Comm. on Taxation, 103rd Cong., 1st Sess., Summary of the President's Revenue Proposals 32 (Comm. Print 1993). This part of the President's proposals has been adopted in both the House and Senate versions of the pending tax legislation and thus the maximum rate may likely rise again to 55%. H.R. 2264, 103d Cong., 1st Sess. § 14208 (1993); S. 1134, 103d Cong., 1st Sess. § 8208, (1993). However, for convenience and consistency, the 50% maximum rate is used throughout this article.

4. IRC §§ 102(a); 1001(a), (b).

5. See infra Part II B 3.

6. If the total gifts made to one donee within a calendar year exceed $10,000, the annual exclusion applies to the first $10,000 of the gifts. IRC § 2503(b).

7. IRC § 2503(a), (b); Regs. § 25.2503-3; see infra notes 100-02 and accompanying text.

the federal transfer tax system.[8] Yet, at the same time, the annual exclusion is not large enough to protect some types of transfers that should be protected from gift tax.[9] In addition, as it is currently designed and used, the annual exclusion injects vertical inequity into the transfer tax system and contributes to horizontal inequity that exists in the system.[10]

This article identifies problems with the annual exclusion and suggests modifications that, if enacted, would both eliminate abusive uses of the exclusion and expand sound policy based uses of other exclusions. Part II of the article briefly sets forth the basic structure of each branch of the federal transfer tax system—the estate tax, the gift tax and the generation-skipping transfer tax. It then examines the historical relationship between the gift tax and the other federal transfer taxes and demonstrates that the annual exclusion from gift tax is actually an exception to each branch of the federal transfer tax system. Part III explores the history and purposes of the annual exclusion and the technical requirements for its use and discusses current uses made of it, some of which uses are inconsistent with its underlying policy justification. Part IV explores and analyzes problems in the transfer tax system caused by the annual exclusion as it is currently designed and used. Part V discusses possible modifications of the exclusion.

This article concludes that, because of enforcement and administration concerns and in order to limit government intrusion into daily life, it is desirable to retain the annual exclusion in some form, but it should be substantially modified. The most desirable modifications are to: (i) reduce the annual exclusion to that amount of incidental gifts made on average by persons with approximately $600,000 of wealth; (ii) place a cap on the annual exclusion of $20,000 per year, per *donor*; (iii) allow the annual exclusion only for outright gifts or for gifts to trusts that may make distributions only to one beneficiary and that require inclusion of any amount not so distributed in that beneficiary's gross estate; and (iv) expand existing exclusions for tuition gifts and medical care gifts, which exclusions should include expenditures made for housing, food, books and other expenses common to education and to care of the elderly and other persons unable to provide for themselves. Attached as an appendix to this article is draft statutory language designed to accomplish the proposed changes in the law. Specifically, the statutory language modifies the annual exclusion and creates a gift tax exclusion for transfers for student expenses and for expenses of the elderly and incompetent.

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8. See infra Part III C 1. The term "federal transfer tax system" means the gift tax, the estate tax, and the generation-skipping transfer tax taken in combination.

9. See infra Part III C 3.

10. See infra Part IV B, C.

II. THE RELATIONSHIP OF THE FEDERAL TRANSFER TAXES

To understand the significance of the annual exclusion, the opportunity to avoid federal transfer tax that it represents, and the degree to which it is inconsistent with the general purposes of the transfer tax system, it is necessary to have an understanding of that system and of its historical purposes and development. This Part II provides the appropriate background.

A. *The Federal Estate Tax*

1. *Overview.*—The federal estate tax, originally adopted in 1916, is an excise tax imposed upon the transfer of property at death.[11] A major reason for taxing estates, in addition to generating revenue, was breaking up concentrations of wealth.[12] Subject to the exceptions discussed below, the

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11. Revenue Act of 1916, Pub. L. No. 64-271, §§ 200-212, 39 Stat. 756, 777-80 (1916); IRC § 2001(a).

12. With respect to the revenue raising purposes behind its original adoption, see H.R. Rep. No. 922, 64th Cong., 1st Sess. 1-5, and S. Rep. No. 793, 64th Cong., 1st Sess. 1-4, both reprinted in 93 U.S. Revenue Acts 1909-1950 (B. Reams ed.) (1979). As to the purpose of breaking up concentrations of wealth, see the testimony given on the estate tax before the House Ways and Means Committee between October 19 and November 3, 1925, with respect to proposed revenue revisions, reprinted in 7 U.S. Revenue Acts 1909-1950, at 293-510, especially the statement of Rep. Ramseyer from Iowa, who introduced an article by Andrew Carnegie to support the notion that an estate tax was an appropriate tax to impose. Id. at 398-418. There was also substantial testimony in favor of repeal of the estate tax. However, it was not repealed, although the exemption was increased and the rates reduced by the Revenue Act of 1926, Pub. L. No. 69-20, §§ 300-325, 44 Stat. 9, reprinted in 97 U.S. Revenue Acts 1909-1950, at 67-87. H.R. Rep. No. 1, 69th Cong., 1st Sess. 14-15, reprinted in 97 U.S. Revenue Acts 1909-1950. Again, in testimony before the Ways and Means Committee between October 31 and November 10, 1927, by William C. Roberts, representing the American Federation of Labor, Chester H. Gray, representing the American Farm Bureau Federation, and Rep. Ramseyer, reprinted in 8 U.S. Revenue Acts 1909-1950, at 747-75, the use of the estate tax to break up concentrations of wealth and to redistribute wealth were apparent. Finally, in hearings leading up to the Revenue Act of 1932, Pub. L. No. 72-154, 47 Stat. 169, reprinted in 9 U.S. Revenue Acts 1909-1950, at 427-434, the statements of Rep. Ramseyer again emphasized the use of the tax to prevent concentrations of wealth. The 1932 Act substantially increased the estate tax rates and adopted a gift tax as well. Revenue Act of 1932, §§ 401-509.

There has been, through the years, a lively discussion in the literature over whether the transfer tax system should be retained or eliminated or replaced. See, e.g., George Cooper, A Voluntary Tax? New Perspectives on Sophisticated Estate Tax Avoidance, 1977 Colum. L. Rev. (1977); Joel C. Dobris, A Brief for the Abolition of All Transfer Taxes, 35 Syracuse L. Rev. 1215 (1984); Joseph M. Dodge, Beyond Estate and Gift Tax Reform: Including Gifts and Bequests in Income, 91 Harv. L. Rev. 1177 (1978); Charles O. Galvin, To Bury the Estate Tax, Not to Praise It, 52 Tax Notes 1413 (Sept. 16, 1991); Michael J. Graetz, To Praise the Estate Tax, Not to Bury It, 93 Yale L. J. 259 (1983); Harry L. Gutman, Reforming Federal Wealth Transfer Taxes After ERTA, 69 Va. L. Rev. 1183 (1983); David M. Hudson, Tax

tax is imposed on the transfer of all property owned by an individual at death, and on other property as to which the decedent, either at death or within the three years preceding death, had certain types of control or from which the decedent benefited either at death or within the three years preceding death.[13] The tax is calculated on the basis of the fair market value of the property transferred determined as of the date of death or, in some circumstances, as of the date six months after death.[14]

The estate tax applies only to persons who make cumulative transfers, during life and at death, in excess of $600,000.[15] The maximum estate tax

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Policy and the Federal Taxation of the Transfer of Wealth, 19 Willamette L. Rev. 1 (1983); Thomas A. Robinson, The Federal Wealth Transfer Taxes—A Requiem?, 1 Am. J. Tax Policy 25 (1982); G.P. Verbit, Do Estate and Gift Taxes Affect Wealth Distribution?, 117 Tr. & Est. 598 (1978).

This article assumes that the federal transfer tax system will be retained, without judging whether it should be.

13. IRC §§ 2001(a), 2031, 2033-2045, 2051. Section 2001(a) directs that the tax be imposed on the "taxable estate of every decedent who is a citizen or resident of the United States." The taxable estate is defined in section 2051 as the "gross estate" minus deductions that are allowed by sections 2053-56. The gross estate includes the decedent's probate estate. IRC § 2033. In general, it also includes property of which the decedent made a gratuitous or partially gratuitous transfer during life and:

(i) Retained for his life the possession, enjoyment of, or the right to income from the property, or the right to designate the persons who shall possess or enjoy the property or the income therefrom (IRC § 2036);

(ii) Where possession or enjoyment of the property can be obtained only by surviving the decedent and the decedent has a reversionary interest which, immediately before death, exceeds 5% of the value of the property (IRC § 2037); or

(iii) Where the enjoyment of the property was at the decedent's death subject to a power held by the decedent to alter, amend, revoke or terminate (IRC § 2038).

The major additional categories of property includable in the gross estate are: annuities that were payable to the decedent and which become payable to another at the decedent's death (IRC § 2039); the decedent's interest in joint tenancies with right of survivorship or tenancies by the entirety (IRC § 2040); property which the decedent had the power to appoint to himself, his estate, his creditors or the creditors of his estate (IRC § 2041); life insurance on the decedent's life over which the decedent had any incident of ownership or which is payable to the decedent's executor (IRC § 2042); and property in which a surviving spouse has certain rights and as to which the estate of the first dying spouse was permitted a deduction (IRC § 2044).

A detailed discussion of each of these provisions is beyond the scope of this article. The interested reader should consult Stephens, et al. supra note 3, at ¶ 4.08.

14. IRC §§ 2031, 2032. As with the gift tax system, the "willing buyer, willing seller" test is used to determine fair market value. See supra note 2; Regs. § 20.2031-1(b).

15. IRC §§ 2001, 2010. Section 2010 provides every citizen or resident of the United States who is subject to the estate tax a credit of $192,800, against the estate tax. Under the current rate schedule that credit is sufficient to offset estate tax on property worth up to $600,000. The original estate tax affected persons with estates (net of certain expenses) of $50,000 or more. Revenue Act of 1916, Pub. L. No. 64-271, § 203, 39 Stat. 756. There

rate currently is fifty percent.[16] There is an additional five percent tax, imposed on the portion of an estate between $10 million and $18.34 million, which operates to deny large estates the benefit of both (i) a $192,800 credit against transfer tax available to all other taxpayers, and (ii) the lower estate tax rate brackets applicable to the first $2.5 million in an estate.[17]

The potential impact of the estate tax on those to whom it applies has increased because it has been supplemented by the other two elements of the transfer tax system: (i) the federal gift tax, enacted in 1932, which applies to lifetime gratuitous transfers of property;[18] and (ii) the generation skipping transfer tax, enacted in 1986, which applies to transfers benefiting more than one generation of a family.[19] As is discussed below, each of these other transfer taxes makes it more difficult to avoid transfer tax.

The potential bite of the transfer tax on transfers of substantial amounts of wealth, and particularly on multigenerational transfers, is fearsome. Amounts in excess of $600,000 which do not qualify for any exception are subjected to tax at a rate of thirty-seven percent and the rate increases to fifty percent for taxable transfers over $2.5 million.[20] Accordingly, the rate of tax imposed on those estates that actually incur it is immediately substantial and can be as much as one-half of the aggregate property. When imposed in conjunction with the generation-skipping transfer tax (discussed below), the rates can reach seventy-five percent.[21] This makes

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have recently been proposals introduced in Congress both to reduce and to increase the unified credit. H.R. 1110, 103d Cong., 2d Sess. (1993); S. 531, 103d Cong., 1st Sess. (1993); H.R. 4848, 102d Cong., 2d Sess. (1992).

16. IRC § 2001(c)(1). Originally, the maximum rate was 10% in 1916 and climbed to 77% at the time the 1954 Code was adopted. Revenue Act of 1916, § 201, IRC § 2001 (1954). See discussion supra note 3.

17. IRC § 2001(c)(3). This five percent rate applies to amounts in taxable estates between $10,000,000 and $18,340,000. It was adopted as a part of the Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203, §10401(b)(1) (1987). According to H.R. Rep. No. 100-391, 100th Cong., 1st Sess. 1040 (1987), the purpose of adopting this surtax was to retain the benefits of the graduated rates and the unified credit for smaller estates, while continuing the effectiveness of the estate tax system in its role of maintaining the progressivity of the overall federal tax structure.

18. See infra Part II B.

19. See infra Part II C.

20. A $192,800 credit available to all taxpayers offsets tax that would otherwise be due on $600,000. IRC §§ 2001(c), 2010. Once the credit is used up, the first dollar of the taxable estate over $600,000 is taxed at 37% and the rates increase to a maximum of 50% for taxable estates over $2,500,000. IRC § 2001(c).

21. The generation-skipping transfer tax can be a flat 50%. IRC §§ 2001(c), 2641. With respect to some types of transfers that are ultimately subject to the generation-skipping tax, the estate tax is paid on the property and the full amount of property that remains after estate tax is paid is subjected to generation-skipping tax as well. IRC §§ 2611, 2612(a), 2622(a). For example, assume a bequest of $1,000,000 into trust is subject to a 50% estate tax

avoidance of estate tax a highly desirable goal for those with considerable amounts of wealth.

2. *Major Exceptions.*—There are four significant exceptions to the estate tax. First, testamentary transfers of property to the transferor's surviving spouse, or to certain types of trusts for the lifetime benefit of the surviving spouse, are free of estate tax.[22] This is referred to as the "marital deduction."[23] However, property transferred under the marital deduction is ultimately subject to estate tax when the surviving spouse dies, assuming it is not consumed by the survivor.[24] Thus, the marital deduction *defers* the

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(because the taxpayer has already fully used his unified credit and lower estate tax brackets), and that the remaining $500,000 is held in trust for the benefit of the transferor's child for the child's life, remainder to the transferor's grandchild. When the child dies, if the entire trust is subject to generation-skipping tax and the trust assets are still worth $500,000, the $500,000 is taxed again at 50%, leaving $250,000 in the hands of the grandchild. The total transfer tax payment ($500,000 estate tax and $250,000 generation-skipping tax) is 75% of the original $1,000,000 bequest.

22. IRC §§ 2056, 2056A. Section 2056(a) generally permits a deduction from the gross estate for any amount that passes from the decedent to the decedent's surviving spouse in accordance with the terms of section 2056(c). This deduction is available for amounts passing to the surviving spouse outright or in one of three types of trusts, the terms of which are governed by section 2056(b). Section 2056(d) disallows the deduction where the decedent's surviving spouse is not a citizen of the United States out of concern that the property will be removed from the United States by the surviving noncitizen spouse and hence will forever escape estate tax. Nonetheless, under section 2056(d)(2), it is possible for a decedent with a surviving noncitizen spouse to defer estate tax on property placed in a trust for the benefit of the surviving noncitizen spouse if the trust satisfies the requirements of section 2056A. The primary requirement is that at least one trustee be an individual citizen of the United States or a domestic corporation. That trustee is responsible for collecting any estate tax ultimately due.

23. This is the term used in the heading to section 2056(a).

24. This is the trade-off imposed for granting the marital deduction. The unlimited marital deduction allowed by current law has its roots in a policy which favors permitting both spouses in a couple to be able to benefit from all the property that both have accumulated, rather than requiring any estate tax to be paid at the death of the first to die. Staff of Joint Comm. on Taxation, General Explanation of the Economic Recovery Tax Act of 1981, at 231-34, reprinted in Internal Revenue Acts 1980-1981, 1369 at 1602-05 (West 1982). Thus, for these purposes a married couple is considered a single unit. When the surviving member of the couple dies, there is no further reason to delay imposition of the tax. All of the methods by which property can be qualified for the marital deduction when passed from the first spouse to die to the survivor ensure that the property will be included in the estate of the survivor. Obviously, if the first-to-die leaves property to the survivor outright, it will be in the survivor's estate to the extent not consumed nor given away under section 2033. Of the types of trusts that can be used to take advantage of the marital deduction, one requires that the property in the trust be paid to the survivor's estate, Regs. § 20.2056(e)-2(b)(1), Ex. (iii); there is a special statute, section 2044, which specifically includes the property from a second type of marital deduction trust in the survivor's estate; and the third type of marital deduction trust must give

estate taxation of property, but it does not allow avoidance of estate tax.

Second, testamentary transfers for charitable purposes are free from federal estate tax.[25] However, the property which escapes tax under this exception is usually paid to charity and is not available to the transferor's family or to other individual beneficiaries.[26] Hence, the family wealth is reduced by such transfers.

A third major exception to the application of the estate tax under current law is the unified credit—a $192,800 credit provided to all taxpay-

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the survivor a general power of appointment over the trust property, which ensures its inclusion in the survivor's estate under section 2041.

25. Section 2055 permits an unlimited deduction for estate tax purposes for amounts passing from a decedent to charity.

26. Obviously, outright transfers to charity remove the property for which the deduction is granted from the beneficial enjoyment of the decedent's family or other beneficiaries. Section 2055(e)(2) also permits an estate tax deduction for so called "split interest" trusts, which are trusts that can benefit charity and private persons. Generally, such trusts must be in a form that either: (i) pays an annuity to a charity, with remainder to private persons; (ii) vice versa; (iii) pays a "unitrust" amount (a fixed percentage of the value of the trust assets with the value redetermined annually) to a charity, with remainder to private persons; or (iv) vice versa. Hence, the decedent can benefit charity and his family from the same property. With respect to a split-interest trust that pays an annuity to charity, the deduction is granted only for the present value of the annuity, and that value is in fact removed from the decedent's individual beneficiaries as it is paid. IRC § 2055(a), (e). If, in the alternative, the remainder passes to charity, the deduction is granted only for the present value of the remainder. Id. Accordingly, other than to the degree the interest rate assumption used in calculating the present value of the annuity or remainder turns out to be an incorrect estimate of what rates will be during the period involved, the value for which a deduction is granted is also removed from the decedent's beneficiaries other than charity.

It should be noted that it is possible for the decedent's individual beneficiaries to have a substantial voice in how the wealth passing to charity is used. For example, through a combination of sections 501(c)(3) and 2055 it is possible for a decedent to establish a private foundation in the form of a trust or corporation and name family members as the trustees or directors. Although such foundations are subject to numerous restrictions (see IRC §§ 4940-4946), the decedent's nominees, if they serve, can decide what causes, and therefore, to some extent, what persons, ultimately benefit from the decedent's largesse.

It is also possible for the decedent's individual beneficiaries, in their capacity as trustees or directors, to receive compensation for services actually rendered in administering the property for charity. A private foundation, like any other charitable entity, may pay its ordinary and necessary expenses of operation without losing its exempt status. IRC §§ 4940(c)(3), 4941(d)(2)(E); Regs. § 53.4940-1(e)(1). Reasonable compensation of officers is an ordinary and necessary expense of operation. Id.; Bruce G. Hopkins, The Law of Tax Exempt Organizations, 217-19 (4th ed. 1983).

Such persons may even benefit in various limited ways directly from the property that produces the wealth that goes to charity. This would occur where one or more of the decedent's individual beneficiaries receive the annuity, unitrust payment or remainder from a split-interest trust.

ers.[27] Like all credits, it applies to reduce the tax due dollar for dollar. It thus reduces any estate tax due to the extent it has not been consumed through lifetime transfers.[28] Based on the present estate tax rate tables, the credit of $192,800 permits $600,000 worth of property to be transferred at death without estate tax.[29] One function of the credit is to remove most individuals from the reach of the estate tax and to permit all of their property to pass free of estate tax.[30] With proper planning, each spouse in a married couple can utilize his or her unified credit and thus pass to their beneficiaries $1.2 million worth of property and not incur estate tax.[31] As noted above, an add on rate of five percent is applied to estates over $10 million, which serves to phase out the benefit of the credit.[32]

The fourth method of reducing or avoiding estate tax is to make a gift of property. While the gift may be subject to gift tax, that tax is imposed on

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27. IRC § 2010.

28. See infra note 51 and accompanying text.

29. The current estate tax rate schedule provides that taxable estates over $500,000 and not over $750,000 owe estate tax of $155,800 plus 37% of the excess over $500,000. A $192,800 credit would thus fully protect $500,000 from tax, with $37,000 of credit left. A $37,000 credit at a 37% rate protects another $100,000 from tax for a total of $600,000. IRC §§ 2001, 2010.

30. S. Rep. No. 144, 97th Cong., 1st Sess. 124 (1981), reprinted in 1981 U.S.C.C.A.N. 226; Staff of Joint Comm. on Taxation, General Explanation of the Economic Recovery Tax Act of 1981, at 227, reprinted in Internal Revenue Acts of 1980-1981, 1369 at 1598 (West 1982).

31. Since each taxpayer is automatically provided the credit, each member of a married couple can pass $600,000 of property without estate tax consequences. This does take some planning, since the unified credit only operates on tax due on property in the taxpayer's taxable estate. If H and W are married and W has $1,200,000 of property and H none, and H dies first, H's unified credit is wasted because there is no tax due against which to apply his credit. When W dies, her unified credit will protect one-half of her property from estate tax, but the other one-half will be taxed. Alternatively, if H and W each have $600,000, then each could make use of the credit and protect $1,200,000 from tax. If the survivor needs the benefit of the $600,000 held by the first to die, then the first to die can, at death, leave his or her $600,000 in a trust which can benefit the survivor but is not included in the survivor's gross estate for estate tax purposes. Hence, the $600,000 held by the first to die passes free of tax at his or her death because of the unified credit, and is not taxed at the survivor's death because it is not included in the survivor's gross estate. The $600,000 held by the survivor will pass free of tax at the survivor's death under the survivor's own unified credit. Hence, the couple can pass $1,200,000 free of tax. Note that in order to use the unified credit, the property of the first to die must not qualify for the marital deduction. That is because deductible amounts are not included in the taxable estate (IRC § 2051) and thus give rise to no estate tax against which the credit can be applied. For criticism of the complexity the existing system engenders, and a suggestion that the system be altered to allow the credit of the first to die to be passed to the surviving spouse, see Robert B. Smith, Unifying the Unified Credit, 39 Fla. L. Rev. 1153 (1987).

32. See supra note 17 and accompanying text.

the value of the gift at the time of the transfer. If the property that is the subject of the gift appreciates after the date of the gift, the appreciation is subject to neither gift tax nor estate tax vis-a-vis the donor. Accordingly, a gift under the annual exclusion is an especially attractive way to avoid estate tax because it incurs no gift tax, uses none of the donor's unified credit, and, if the annual exclusion gift appreciates, the appreciation also escapes gift and estate tax. Gift tax is also calculated in a way different than estate tax, and in some instances this difference makes it advantageous to make a taxable gift rather than hold the property until death.[33]

B. *The Federal Gift Tax*

1. *1932 to 1977.*—When the federal estate tax was first introduced in 1916, no federal tax on gratuitous lifetime transfers was enacted with it.[34] Presumably, it did not take long for advisors to those subject to the new estate tax to urge their clients to make lifetime gifts of substantial amounts of property. Since lifetime gifts were not subject to any federal transfer tax and property owned at death was subject to such a tax, gifts were an easy way to reduce the federal estate tax liability. Between 1916 and 1932 a couple of interim measures were used in an effort to limit the use of gifts as an estate tax avoidance technique, but neither proved workable.[35] In 1932, Congress finally decided to narrow this estate tax escape hatch with a comprehensive set of provisions, the federal gift tax.[36]

The principal purpose of the federal gift tax is to "back-up" the estate tax and prevent the avoidance of estate tax by lifetime transfers.[37] Like the estate tax, the federal gift tax is an excise tax on the transfer of property.[38]

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33. See infra notes 56-58 and accompanying text.

34. Revenue Act of 1916, §§ 200-212; Revenue Act of 1924, §§ 319-324, 43 Stat. 253 at 313-16; Stephens, et al. supra note 3.

35. In sections 319 through 324 of the Revenue Act of 1924 Congress adopted a gift tax, which was repealed in section 1200 the Revenue Act of 1926. In the same act, Congress adopted a conclusive presumption that gifts made within two years of death were made in contemplation of death and should thus be included in the donor's estate. Large gifts made shortly before death so as to avoid the estate tax were thus dealt with by making them subject to the estate tax. Revenue Act of 1926, § 302(c). However, the conclusive presumption of contemplation of death was held unconstitutional in Heiner v. Donnan, 285 U.S. 312 (1932).

36. Revenue Act of 1932, §§ 501-31. Currently, the gift tax is found in sections 2501-2524.

37. Stephens, et al. supra note 3.

38. IRC § 2501; Branley v. McCaughn, 280 U.S. 124 (1929) (holding the 1924 gift tax, imposed on the transfer of property, to be constitutional as an excise tax, rather than a direct tax which the Constitution requires be apportioned among the states in proportion to their population). Current law, like the 1924 provisions, provides for imposition of the tax upon the "transfer" of the property, not the property itself or even the ownership of the

Its purpose suggests, of course, that the gift tax and estate tax should be so integrated that the use of a lifetime gift to transfer property does not provide any transfer tax savings as compared to a testamentary transfer of the same amount.[39] Accordingly, all gratuitous transfers by one donor should be aggregated and taxed under a single set of rates.[40] The transfers may be made at different times during the course of the donor's life and at death, but the total tax collected on the aggregate transfers should be the same as if all the transfers were made at one time and the tax collected then.

Consistent with this notion, from its inception in 1932, the federal gift tax has required that the tax due on any *gift* be calculated on an aggregate basis.[41] This is accomplished by aggregating all prior taxable gifts made by the same donor with any current taxable gift, calculating the gift tax due on the total, and reducing the amount so determined by the tax that would have been paid on the previous gifts using the existing rate schedule.[42]

Notwithstanding the central purpose of having both a gift and estate tax, the gift tax as originally enacted, and for nearly forty-five years thereafter, had its own rate structure which was separate from the estate tax rate structure and under which each rate applicable to a taxable gift amount was lower than the corresponding estate tax rate on the same amount passing at death.[43] Further, from 1932 until 1977, lifetime gifts were not taken into

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property, and thus is an excise tax.

39. If there is to be a tax upon both lifetime and testamentary transfers of property, there is no obvious reason to make the tax on one type of transfer higher or lower than on the other type. To do so would obviously create an incentive to make the type of transfer that is taxed at a lower effective rate. See, e.g., H.R. Rep. No. 1380, 94th Cong., 2nd Sess., 10-15 (1976), reprinted in 1976-3 C.B. 744-49.

40. If transfers made during life and at death are taxed at different rates, the incentive referred to in note 39 will exist. If transfers made during life and at death are taxed at the same rates, but are not taxed cumulatively, then making lifetime gifts and testamentary transfers would enable the transferor to make use of at least the lower rate brackets applicable to each type of transfer, which is itself an incentive to make gifts as well as testamentary transfers.

For example, if both types of transfers had *separate*, identical brackets of 10%, 20%, 30%, 40% and 50%, then it would make sense for a wealthy person to make lifetime gifts sufficient to get to the 50% level, so as to be certain to have used the brackets under 50%. At death, his or her estate would get to use the 10-50% brackets of the separate estate tax again. This opportunity to use lower rates *twice* is avoided if all transfers are taxed cumulatively under *one* rate structure. Hence, if at death the taxpayer's estate is "stacked" on top of lifetime gifts the same taxpayer made, and a single rate structure is used, the estate is boosted into the higher brackets and the dual use of lower brackets is avoided.

41. Revenue Act of 1932, § 502; IRC § 2502(a), (b).

42. IRC § 2501(a)(1), (2).

43. Compare section 401 with section 502 of the Revenue Act of 1932. Also compare the rates set forth in sections 2001 (estate tax) with those set forth in section 2502 (gift tax) of the Internal Revenue Code of 1954, as amended through 1976.

account in determining the tax rate applicable to testamentary transfers.[44]

2. *1976 Tax Reform Act Changes.*—In the Tax Reform Act of 1976, Congress took several steps to integrate the estate and gift tax systems. First, it repealed the separate estate and gift tax rates and adopted a single set of rates to be imposed on all taxable gifts and testamentary transfers.[45] Second, it ordained that the value of all taxable lifetime gifts made by an individual after 1976 should be taken into account in determining the transfer tax rate applicable to the same person's estate at death.[46] Thus, under the post-1976 system, all of an individual's taxable lifetime gifts (except for those made before the change in the law) are added to the value of the property that the individual transfers at his death in order to determine the rate of tax applicable to the property transferred at death.[47]

The major reason stated for making these changes was vertical equity.[48] Under the pre-1976 Act rules, very wealthy individuals could afford to make large lifetime gifts and take advantage of the lower gift tax rates. However, other individuals who would incur estate tax at death, but who could not afford to make large gifts, were forced to incur the higher estate tax rates on their property.

3. *Exceptions to the Application of the Gift Tax.*—Because the 1976 amendments impose the same tax rates on testamentary and lifetime transfers, gifts can also now be taxed at rates of up to fifty percent.[49] Hence, avoiding

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44. Thus, for example, from 1932 through 1976, a $250,000 lifetime gift was taxed at a lower rate than a testamentary transfer of $250,000. Further, if the person making the $250,000 gift died still owning $500,000 worth of property, the prior transfer of $250,000 was *not* taken into account in determining the estate tax rate applicable to the $500,000.

45. Tax Reform Act of 1976, § 2001(a)(1), 90 Stat. 1846.

46. Id.

47. For example, in footnote 44 above, assume that an individual makes total lifetime taxable gifts after 1976 of $250,000 and dies with $500,000 in his estate. After the 1976 amendments, only one set of tax rates apply to both transfers. IRC §§ 2001(c), 2502. Further, to determine the tax on the $500,000 testamentary transfer, the $250,000 worth of taxable gifts is added to the $500,000 and the amount of tax due on a $750,000 transfer is determined. IRC § 2001(b)(1)(A), (B). From the tax due on $750,000, the tax that would currently be paid on a $250,000 transfer is *subtracted*, thus effectively crediting the taxpayer for the gift tax paid. IRC § 2001(b)(2). The *difference* is the tax presently due on the $500,000 transfer. Thus, all gratuitous transfers are taxed cumulatively. This approach more closely approximates a system under which the transfer tax due on any transfer is the same, whether the transfer is made during lifetime or at death.

48. H.R. Rep. No. 94-1380, 94th Cong., 2d Sess. 10-15, reprinted in 1976-3 C.B. 744-49.

49. IRC § 2502(a) (requiring the estate tax rate table set forth at section 2001(c) be used to make gift tax calculations).

gift tax on lifetime transfers can be very desirable.

There are several exceptions to the gift tax which correspond to the exceptions to estate tax discussed above and which can be used to avoid or postpone transfer tax. Gifts to charity are not subject to gift tax, gifts to spouses or into certain types of trusts for spouses are not subject to gift tax, and the first $192,800 of gift tax due is offset by the unified credit.[50] Thus, due to the unified credit, an individual may make taxable gifts of $600,000 without paying any tax out-of-pocket. If the credit is used to offset tax due on lifetime transfers, it will not be available to reduce estate taxes due at death.[51] In addition to these exceptions, which are similar to the exceptions to the estate tax, amounts paid on behalf of any other person as tuition to educational institutions that meet certain criteria (meant to ensure that the institutions are bona fide) are not subject to gift tax.[52] Neither are amounts paid to a medical care provider for the medical care of any other person.[53]

Finally, there is the annual exclusion from gift tax. Under the annual exclusion, an individual may make annual gifts of property to any number of

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50. IRC §§ 2522 (allowing a deduction in computing taxable gifts for the amount given to charity), 2523 (allowing a deduction for transfers to donor's spouse), 2505 (allowing $192,800 credit against gift tax due reduced by amount of credit previously used).

51. IRC § 2001(b). It is not immediately obvious how the calculation required by this section reduces the unified credit available to the decedent's estate if lifetime use of the credit has been made. It does so by requiring that an amount equal to all of a decedent's post-1976 taxable gifts be added to the decedent's taxable estate for purposes of calculating the estate tax. While gifts covered by the $192,800 unified credit do not cause tax to be paid out-of-pocket, they are, nonetheless, taxable as defined in section 2503, and, thus, are added to the taxable estate. Any credit used during life is restored to the decedent's estate and a credit is provided for any out-of-pocket gift tax paid. However, because the prior taxable gifts are added back, these siphon off the benefit of any credit used during lifetime and any gift tax paid. The net result is that the decedent's taxable estate is boosted into higher brackets.

52. IRC § 2503(e)(2)(A).

53. IRC § 2503(e)(2)(B). The payments must be for medical care as defined in section 213(d)(1), which states:

> (1) The term "medical care" means amounts paid—
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> (A) for the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body,
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> (B) for transportation primarily for and essential to medical care referred to in subparagraph (A), or
>
> (C) for insurance (including amounts paid as premium under Part B of Title XVIII of the Social Security Act, relating to supplementary medical insurance for the aged) covering medical care referred to in subparagraphs (A) and (B).

In addition, lodging while away from home primarily for and essential to medical care is also within the medical care definition, if the care is provided by a physician in a licensed hospital or the equivalent thereof, but the amount is limited to $50 per night. IRC § 213(d)(2). Prescribed drugs are also within the definition. IRC § 213(b), (d)(3). Cosmetic surgery is not within the definition. IRC § 213(d)(9).

persons of up to $10,000 each without incurring any gift tax, so long as the gift is not a gift of a future interest in property.[54]

4. *Important Continuing Advantages of Making Gifts, Including Use of the Annual Exclusion.*—Despite the significant 1976 changes, there are still three important advantages to making lifetime gifts rather than testamentary transfers.

a. *Removal of Appreciation From the Donor's Estate.*—As noted above, the transferor is not subject to transfer tax on any appreciation that occurs with respect to the transferred property *after* the date of the gift.[55] If the same property were held until death, any such appreciation would be subject to estate tax.

b. *Gift Tax Is Calculated on a Tax Exclusive Basis.*—Second, although the estate and gift tax systems now use the same rates to calculate the amount of tax due, the method of making the calculation differs in a way that favors lifetime gifts. When an individual dies, *all* of his property is subject to estate tax, *including* the assets used to pay the estate tax.[56] However, gift tax is imposed only on the amount given away by the transferor. The payment of gift tax by the transferor is not viewed as an additional gift, but rather the satisfaction of a legal obligation.[57] Thus, the dollars used to pay gift tax are generally not subject to gift or estate tax.[58]

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54. IRC § 2503(b).

55. The estate tax generally applies to property in which the decedent has some interest or over which he has some control at death. IRC §§ 2031-2044. Property the decedent gave away absolutely during life is thus not included in the decedent's estate. See IRC § 2031; Regs. § 20.2031-1. While an amount equal to any post-1976 taxable gifts is added to the taxable estate, any unified credit used or gift tax paid is effectively used to offset the tax caused by this inclusion. See discussion supra note 51. There are a few types of property interests which, if given away within three years prior to the decedent's death, are brought back into a decedent's estate *at date of death* values, but these are exceptions. IRC § 2035(d)(2).

56. The estate tax is imposed on the decedent's taxable estate. IRC § 2001(b)(1)(A). In calculating the estate tax due, no deduction from the gross estate is granted for the payment of estate tax. Cf., IRC §§ 2051-2056A (listing all deductions permitted for estate tax purposes and not granting any deduction for federal estate tax paid).

57. IRC § 2502(c).

58. There is an exception to this rule only where the donor dies within three years after making the gift. IRC § 2035(c). In that situation, the gift tax the donor paid is included in his estate and is subject to estate tax. Id. Unless this exception applies, however, paying gift tax on a specific amount is less burdensome than paying estate tax thereon.

To illustrate, assume an individual wants to transfer $1 million to his children. Further assume that the estate and gift tax rate on all gratuitous transfers is a flat 50%. If the

c. *The Annual Exclusion.*—The third major advantage to making lifetime gifts is the use of the annual exclusion. Because the exclusion is calculated on a per year, per donee basis, an individual who has the resources can transfer substantial amounts of wealth under the exclusion. For example, if the individual has nine donees, the individual can give $10,000 to each donee each year, thus transferring a total of $90,000 a year. If the individual is married, the individual and the individual's spouse can *each* give $10,000 to each donee each year, for a combined gift of $20,000 per donee. If one of the two spouses has $20,000 to give away and the other has no property to give away, the one with the $20,000 can make the gift and the couple can treat the $20,000 gift as a $10,000 gift from each.[59]

Transfers made under the annual exclusion are completely free of estate or gift tax consequences. With respect to an annual exclusion gift, no transfer tax is due, no unified credit is used, and the gift is not taken into account in determining the tax rate applicable to property transferred at death or to later gifts.[60] While the fact that no tax is due on such gifts means annual exclusion gifts do not participate in the second advantage that can accrue to gifts (removal of gift tax paid from the donor's transfer tax base), they do participate fully in the first advantage (any post-gift appreciation is removed from the donor's transfer tax base). Hence, if used regularly and fully, the annual exclusion can be a powerful tool for transferring substantial amounts of wealth.

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individual dies, he must leave $2 million to provide $1 million to the children. That is, on a $2 million estate with a 50% flat rate the estate tax due would be $1 million, leaving $1 million to pass to the children. If the individual gives $1 million to his children during his life, the gift tax due is only $500,000. (Fifty percent of $1 million—this assumes the transferor does not die within three years after making the gift.) Obviously, $500,000 less in total assets has been used to transfer $1 million to the children than was used in the estate tax situation, notwithstanding the facial identity of rates.

There are, however, offsetting costs to making use of this advantage. First, the income that could be earned from the dollars used to pay the gift tax is lost to the donor from the date of the tax payment until the donor's death. Second, the basis of property passing at death is adjusted to date of death values, reducing the chance that the beneficiaries will have any gain upon selling the property. IRC § 1014. Lifetime gifts get a more limited basis adjustment, generally being a portion of any gift tax paid. IRC § 1015(d).

59. IRC § 2513(a), (b). The election to treat a gift made by one donor as made one-half by that donor and one-half by that donor's spouse is made annually and applies to *all* gifts made by *either* during the year. Id. This process is hereinafter referred to as "gift splitting."

60. Section 2503(b) directs that the first $10,000 of gifts made to any person by the donor in a year, which are not gifts of future interests, are to be excluded from the determination of the total amount of gifts made by the donor.

C. *The Generation-Skipping Transfer Tax*

The gift tax limits the opportunity to avoid estate tax through lifetime transfers, even though it does not eliminate it. But neither the gift tax nor the estate tax prevents the design of vehicles that permit property to escape the imposition of transfer tax at the deaths of the transferor's children and grandchildren.[61] Besides outright gifts to grandchildren or great-grandchildren, if the gift and estate taxes were the only transfer taxes, this plan could be accomplished by placing property in trusts with terms that permitted the transferor's children and grandchildren to benefit from the property, but did not give the transferor's children or grandchildren any of the ownership or control rights that would cause the estate tax to apply to the trust property at their deaths.[62] Such trusts came to be known as generation-skipping trusts, because ownership of the property *and* the imposition of estate tax "skipped" one or more generations of the transferor's descendants.

In 1976, Congress enacted a tax on certain generation-skipping transfers.[63] That tax was in effect until 1986 when it was repealed retroactively[64] and replaced with a new tax.[65]

Under the current generation-skipping transfer tax ("GSTT"), property held in trusts that benefit multiple generations may be subject to a flat fifty percent tax when distributed to a person more than one generation younger

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61. For example, although the federal gift tax provisions apply to a gift to the donor's grandchild, or great-grandchildren, nothing in those provisions takes into account that the gift "skips" the intervening generations of the donor's descendants and thus is not subject to transfer tax in those generations' hands. Note that the generation-skipping transfer tax applies regardless of family relation to anyone meeting the age disparity requirements of section 2651(d).

62. Using a trust is advantageous in that it may permit the intervening generations to benefit from the property, may increase the number of generations skipped, and may even allow some or all of those generations to be given some control over the trust property.

For example, if a trust were created by will for the benefit of the testator's child, then for the child's children, and remainder to the child's descendants living 21 years after the death of the child and all the descendants of the child living at the testator's death, the number of generations where estate tax is skipped would be as high as three, if the settlor had great-grandchildren living at his death. If the testator so desired, he could name his child as trustee and permit the child to pay income and, if need be, principal to himself for his health, maintenance and support. Generally, the power to appoint property to oneself is a general power of appointment (IRC § 2041(b)(1)) which causes the property subject to the power to be included in the gross estate of the power holder. IRC §2041(a). However, powers to encroach which are limited to the health, maintenance and support of the power holder are *not* general powers. IRC § 2041(b)(1)(A).

63. Tax Reform Act of 1976, § 2006(a), formerly codified at IRC §§ 2601-2622 (1976).

64. Tax Reform Act of 1986, § 1433(c), 100 Stat. 2731.

65. Id. § 1431(a), codified at IRC §§ 2601-2663.

than the grantor, or when all the beneficiaries of the trust who are only one generation younger than the grantor have died.[66] This roughly approximates the effect of the trust property having been owned by each generation and subjected to estate tax when the members of that generation die.[67]

The tax is also imposed on any transfers which are made directly to a person who is more than one generation younger than the donor, or in trust for the benefit of only such persons.[68] This approximates the result that the gift or estate tax would have caused had the property passed first to the generation immediately following the generation of the donor and then been passed again to the actual recipient. The tax on direct skips is *in addition to* any estate or gift tax due on the same transfer.[69]

There are three basic exceptions to the GSTT: (i) each taxpayer is granted a $1 million exemption which the taxpayer can allocate to selected transfers[70] or, if the taxpayer does not allocate it, it is allocated by statute;[71] (ii) if the donor has a deceased child who left surviving children, the donor can make transfers to those grandchildren without incurring GSTT on a "direct skip";[72] and (iii) there is an exclusion which, to a limited extent, parallels the annual exclusion.[73] The annual exclusion to GSTT is also

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66. IRC §§ 2601, 2611-2613, 2641(a)(1). In various circumstances, the property held by a trust may be wholly, partially or not at all subject to GSTT. The portion of the trust property that is subject to GSTT is taxed at a flat 50%. If less than all the trust property is subject to GSTT, the effective rate measured on the whole trust property may be less than 50%. For example, if four-fifths of the trust property *is* subject to GSTT, then that four-fifths is taxed at 50%, and the effective rate on the whole trust property is 40%.

67. The approximation is very rough, since the GSTT makes no effort to take into account any unused unified credit or unused estate tax brackets available to the "skipped" generation. For example, suppose T dies leaving $1,000,000 in trust to pay income to T's child C for life, remainder to C's child GC at C's death. Assume that all of the $1,000,000 is subject to GSTT and that when C dies, C's own gross estate for estate tax purposes is only $250,000. C's unified credit would have protected an additional $350,000 from estate tax if C had owned that amount. C did not, so that credit is wasted. The GSTT applies to the trust, so $500,000 of tax is due from the trust property. C's unused unified credit can not be used to offset any of this $500,000. Further, C's estate tax bracket was 34%, but under the current GSTT, the trust cannot use the brackets between 34% and 50%.

68. IRC §§ 2612(c), 2613(a), 2611(a)(3). Such transfers are referred to as "direct skips." IRC § 2612(c)(1).

69. Where a direct skip occurs, the taxable amount for GSTT purposes is the amount the transferee receives. IRC § 2623. Hence, if the transferred property is subject to estate tax, the GSTT applies only to the net amount. The payment of the GSTT by the transferor on a lifetime direct skip is considered an additional *gift* to the recipient of the direct skip and this additional gift is subject to gift tax. IRC § 2515.

70. IRC § 2631(a).

71. IRC § 2632.

72. IRC § 2612(c)(2).

73. IRC § 2642(c)(3)(A).

$10,000 per donee.[74] However, it applies to a transfer in trust only if a single individual is the sole lifetime beneficiary of the trust, and, if the individual dies during the trust's existence, the trust terms cause the trust assets to be subject to estate tax as a part of the individual's estate.[75]

There are further exceptions to the GSTT, analogous to those under the gift tax, for transfers that are made to educational institutions for tuition and payments to medical care providers.[76]

D. *A Brief Perspective on the Relationship of the Annual Exclusion to the Federal Transfer Tax System*

As the foregoing demonstrates, the general purpose of the United States transfer tax system is to tax gratuitous transfers of property at rates up to fifty percent. The estate tax applies to testamentary transfers. The gift tax, which is intended to prevent those with substantial estates from escaping the effect of the estate tax by making lifetime gifts, applies to inter vivos transfers. The GSTT serves as an approximate equivalent of an estate tax or gift tax on transfers that would otherwise not incur estate or gift tax at one or more generations below the transferor's generation. The estate tax was originally enacted for the purposes of preventing concentrations of wealth and generating revenue.[77] The other two taxes, which back up the estate tax, must share in those purposes. Through the years Congress has made significant changes to the transfer tax system which have made its application more effective with respect to those with significant amounts of wealth and which have tended to make its avoidance more difficult.[78]

The annual gift tax exclusion permits transfers of $10,000 or $20,000 per donee, and, as is illustrated below, often permits transfers of property

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74. Id. (incorporating by reference the definition of nontaxable gifts under section 2503(b), which sets the $10,000 limit).

75. IRC § 2642(c)(2).

76. IRC § 2642(c)(3)(B) (defining nontaxable gifts for GSTT purposes, in part by reference to section 2503(e), which sets out the gift tax exclusion for tuition and medical care payments).

77. See supra note 12.

78. Admittedly, with the adoption of the unified credit in the 1976 Act and its increase under the Economic Recovery Tax Act of 1981, Congress removed a lot of people from the transfer tax system by increasing from $60,000 to $600,000 the size of an estate that escapes tax entirely. Further, the reduction in the maximum transfer tax rate from 77% in 1975 to 50% in 1993 represented a substantial reduction in the percentage of their wealth that wealthy taxpayers are forced to pay in transfer taxes. Nonetheless, the adoption of the gift tax, its integration with the estate tax, the adoption of the GSTT, the enactment of sections 2701-2704 (dealing with valuation of intra-family transfers for gift tax purposes) and the adoption of the five percent surtax on large estates, viewed in the aggregate, represent an indisputable tightening of the transfer tax system with respect to taxpayers encompassed by it.

with a realizable value likely to be greatly in excess of those stated limits. Hence, it is a highly valuable opportunity to avoid the gift tax. Because the gift property is no longer held by the transferor at death, it is not a part of his estate and thus also escapes estate tax at the transferor's generation so long as the gift is made to a member of a younger generation. Accordingly, the annual exclusion is also an exception to the *estate tax*. Further, if an annual exclusion gift also qualifies for the GSTT annual exclusion, it is also an exception to GSTT. Thus, the annual gift tax exclusion should not be viewed as only a gift tax avoidance mechanism, but as a mechanism for avoiding *all* of the United States transfer taxes and it should be analyzed as such in light of Congress' historical tightening of the transfer tax system.

The next Part of this article explores the historical reasons given for adoption of the annual exclusion, the revisions that have been made to it over the years, the technical requirements necessary for making use of it, the current uses being made of it, and the functions it serves as presently designed. These considerations set the stage for a discussion of problems with the annual exclusion, whether it should be modified and, if so, in what ways.

III. HISTORY OF THE ANNUAL EXCLUSION, TECHNICAL REQUIREMENTS AND CURRENT USES

A. *Historical Development*

1. *The Stated Purpose of the Annual Exclusion.*—An annual exclusion was included in the original 1932 enactment of the predecessor to the current gift tax.[79] The legislative history of the provision reflects only that:

> a gift or gifts to any one person during the calendar year, if in the amount or of the value of $[5],000 or less, is not to be accounted for in determining the total amount of gifts of that or any subsequent calendar year.... Such exemption, on the one hand, is to obviate the necessity of keeping an account of and reporting numerous small gifts, and, on the other, to fix the amount sufficiently large to cover in most cases wedding and Christmas gifts and occasional gifts of relatively small amounts.[80]

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79. Revenue Act of 1932, § 504(b).

80. S. Rep. No. 665, 72d Cong., 1st Sess. 41 (1932), reprinted in 1939-1 (Part 2) C.B. 496, 525-26.

It is clear from this history that the purpose of the annual exclusion is to cover numerous small, normal gifts made annually within families and among friends, and occasional larger wedding and holiday gifts. The $5,000 level in 1932 was a generous exclusion, perhaps overly so for the stated purpose. Plainly, however, the legislative history does *not* contemplate that the annual exclusion would permit an individual to make numerous gifts throughout the year to another individual on normal gift giving occasions *and give a full $5,000* to the same donee. That is, taxpayers were not permitted to treat as nongifts presents given throughout the year on various occasions, such as birthdays, holidays, and weddings, so as to be able to treat the full $5,000 annual exclusion as an opportunity to transfer wealth.

The $5,000 allowance was permitted for the period 1932-38. It was reduced for years 1939 through 1942 to $4,000,[81] and then reduced again in 1942 to $3,000.[82] The legislative history reflects that these reductions were effected because the $5,000 allowance was regarded as inducing donors to "build up estates of considerable size for the members of their families,"[83] and Congress was aware that the exclusion enabled donors to distribute large amounts of property free of gift and estate tax.[84] The reductions in the amount of the exclusion indicate the hostility of Congress to the use of the exclusion for such purposes. Nonetheless, Congress concluded that administrative difficulties would prevent the abolition of the exclusion and, thus, it was reduced but not eliminated.[85]

From 1942 until the effective date of the Economic Recovery Tax Act of 1981 ("ERTA"), the exclusion remained at the level of $3,000.[86] ERTA, in a single step, increased the exclusion from $3,000 per donee, to $10,000 per donee.[87]

2. *The ERTA Changes.*—ERTA was the first of the Reagan era tax bills and it wrought large scale changes to the Code. On the income tax side, it reduced ordinary income tax rates, reduced the capital gains tax rate, permitted the transfer of tax benefits between businesses, liberalized the

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81. H.R. Rep. No. 2330, 75th Cong., 3d Sess. 17 (1938), reprinted in 1939-1 (Part 2) C.B. 817, 830.

82. H.R. Rep. No. 2333, 77th Cong., 1st Sess. 37 (1942), reprinted in 1942-1 C.B. 372, 403.

83. H.R. Rep. No. 1860, 75th Cong., 3d Sess. 61 (1938), reprinted in 1939-1 (Part 2) C.B. 728, 772.

84. H.R. Rep. No. 2333, supra note 82.

85. Id.

86. See Staff of Joint Comm. on Taxation, supra note 30, at 273, reprinted in Internal Revenue Acts 1980-81, 1369 at 1644 (West 1982).

87. Economic Recovery Tax Act of 1981, Pub. L. No. 97-24, § 441(a), 95 Stat. 172, 319 [hereinafter ERTA].

depreciation rules, and generally sought to reduce the tax load on Americans and spur business activity.[88]

ERTA also made substantial changes in the transfer tax system.[89] The changes included the elimination of any dollar or percentage limits on the marital deduction, a near quadrupling of the unified credit, that ultimately increased the amount of property that could be left free of tax to $600,000, a reduction in the uppermost estate and gift tax rates, the aforementioned increase in the annual exclusion, and the addition of the provisions permitting payments for tuition and for medical care to be made free of any gift or estate tax consequences.[90]

The reasons given for most of these changes to the transfer tax system were generally persuasive. The marital deduction change was adopted for equitable reasons: to permit both spouses, including the longer living one, to be supported by all the property accumulated by both spouses, rather than having some property used to pay estate tax on the death of the first to die.[91] The increase in the credit was adopted in order to reduce the number of persons affected by the estate tax, leaving the tax intact with respect to those accumulating over $600,000 ($1.2 million for married couples), but eliminating it for most of the population, including many owning small businesses or family farms.[92] The upper estate and gift tax rates were reduced on the basis of fairness—the seventy percent maximum in effect

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88. See Staff of Joint Comm. on Taxation, supra note 30, at 5-7, 17, 20, 72, 98, reprinted in Internal Revenue Acts 1980-81, 1369 at 1379-81, 1391, 1394, 1441, 1467 (West 1982).

89. Prior to his election to the presidency, Ronald Reagan was several times reported to have favored the repeal of the transfer tax system. See, e.g., John M. Berry, Consensus; Conflict Over Taxes, Political In-Fighting Obscures Vital Differences in Tax-Cut Proposals, Wash. Post, July 27, 1980, at F1; Lou Cannon, On Showcase Farm, Reagan Flails Carter, Wash. Post, Oct. 1, 1980, at A3; Art Pine, The Tax Cut Proposal; Tax Cut in 1981 Would Help Offset Greater Burden of Taxation on January 1, Wash. Post, July 6, 1980, at F1. ERTA, while falling far short of repeal of the transfer tax system, substantially diminished the cost of that system for many wealthy taxpayers by increasing the amount exempt from tax from $175,625 to $600,000 (IRC § 2505), reducing the maximum rate (over the course of several years) from 70% in 1981 to 50% in 1993 (IRC § 2001), increasing the annual exclusion from $3,000 to $10,000 per year, per donee (IRC § 2503(b)), and adopting the unlimited marital deduction (IRC § 2523). The increases in the exempt amount and the annual exclusion prevent many people from ever incurring any estate or gift tax, although these changes did not relieve taxpayers of the burden of reporting gift transfers that do not qualify for the annual exclusion, or exceed it, but do not require any out-of-pocket gift tax payment due to availability of the credit.

90. ERTA, supra note 87, at §§ 401, 402, 403, 441(a), (b).

91. See Staff of Joint Comm. on Taxation, supra note 30, at 233, reprinted in Internal Revenue Acts 1980-81, 1369 at 1604 (West 1982).

92. Id. at 227, reprinted in Internal Revenue Acts 1980-81, 1369 at 1598 (West 1982).

prior to ERTA was deemed simply too large a share for government to take, even given the system's purpose of breaking up concentrations of wealth, because it could force sales of successful closely held and family businesses.[93] The exclusion of medical care and tuition payments addressed concerns about paying for the medical care of the elderly and the college and graduate school education of young adults who were not legally entitled to support under state law.[94]

The increase in the annual exclusion came about with relatively little discussion. There was testimony on behalf of small business owners, from estate tax practitioners, and ABA Section of Taxation representatives, which mentioned the reduced purchasing power of the dollar and the need to increase the annual exclusion to place it at a level where the purchasing power of a full annual exclusion gift was commensurate with the purchasing power of the annual exclusion when the $3,000 level had been adopted in 1942.[95] There was also testimony to the effect that the $3,000 annual exclusion was insufficient to permit an individual to provide college or graduate education to a child at any number of private institutions, where the annual costs far exceeded the $3,000 level, without incurring gift tax liability. Other testimony addressed the difficulty of providing financial assistance to elderly members of the family who needed aid not provided by Medicare or Social Security, or younger (but not dependent) members of the family who needed aid not provided by Medicaid.[96] Of course, these problems were in part corrected by granting the tuition and medical care exclusions. The reasoning behind increasing the annual exclusion 333% *and* also excluding medical care and tuition payments from the gift tax system was not discussed.

The testimony regarding the potential imposition of gift tax on educational and medical expenditures made for another's benefit followed a substantial history of proposals and articles urging that support type transfers be eliminated from the gift tax system.[97] The general thrust of these proposals was to exclude from categorization as gifts intra-family transfers

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93. H.R. Rep. No. 201, 97th Cong., 1st Sess., 156 (1981), reprinted in 1981-2 C.B. 376.

94. See Staff of Joint Comm. on Taxation, supra note 30, at 273, reprinted in Internal Revenue Acts 1980-81, 1369 at 1644 (West 1982); Hearings on S. 395 Before the Subcommittee on Estate and Gift Taxation of the Senate Comm. on Finance, 97th Cong., 1st Sess. 154 (1981) [hereinafter Hearings] (statement of John A. Wallace, Chairman of the Estate and Gift Tax Comm., American College of Probate Counsel); Id. at 174-75 (joint statement of Harvie Branscomb, Jr. and John Nolan, Chairman and Chairman-Elect, Section of Taxation, American Bar Association).

95. See Hearings, supra note 94.

96. See Id.

97. Id. at 212-13 (statement of John A. Wallace, Chairman of the Estate and Gift Tax Committee, American College of Probate Counsel).

made in the form of consumable items or used to acquire consumable items.[98] Congress failed to adopt these broad proposals both in the 1976 reforms and again in 1981. However, by enacting the provisions that permit a gift tax exclusion for tuition and medical care transfers, Congress did address, in a limited way, some of the concerns underlying the earlier proposals regarding transfers for support.

B. *Technical Requirements*

Section 2503(b) establishes only two technical requirements for use of the annual exclusion. The first requires that the gift, together with all other gifts to that donee in that year, not exceed $10,000 in value if the gifts are to be completely protected from gift tax by the annual exclusion.[99] The second requirement is that the gift be of a "present interest" and not of a "future interest."[100] The term "future interest" is not defined in the statute, but the regulations define it by reference to its legal meaning, stating that it "includes reversions, remainders, and other interests or estates, whether vested or contingent, and whether or not supported by a particular interest or estate, which are limited to commence in use, possession, or enjoyment at some future date or time." The regulations state that a present interest is: "an unrestricted right to the immediate use, possession, or enjoyment of property or the income from property (such as a life estate or term certain)...."[101] The fact that a person may have present legal rights with respect to an interest that will not become possessory until some point in the future will *not* convert that right to future possession into a present interest.[102]

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98. A.L.I., Federal Estate and Gift Taxation Recommendations 19 (1969) [hereinafter ALI Proposal]; see infra Part V B.

99. Section 2503(b) states:

> "In the case of gifts (other than gifts of future interests in property) made to any person by the donor during the calendar year, the first $10,000 of such gifts to such person shall not, for purposes of subsection (a), be included in the total amount of gifts made during such year." Subsection (a) defines taxable gifts to mean the total gifts made during the year, less certain deductions available.

100. Id.

101. Regs. § 25.2503-1(b), 3(a). The second part of the quoted regulation acknowledges that the present value of a life estate, life income interest or term for years will qualify for the annual exclusion. This position has been questioned, since clearly most of the benefits to be received by a life tenant or a life income beneficiary will be received in the future, but it has been the position of the regulations for some years. Stephens, et al. supra note 3, at ¶ 9.04[3][a].

102. See Fondren v. Commissioner, 324 U.S. 18, 20 (1945). The exclusion does not become operable just because

the donee has vested rights. In addition, he must have the right *presently* to use,

1. *The Impact of the Present Interest Requirement.*—For a variety of reasons, donors often wish to transfer gifts they make to a trust for the benefit of the donee or donees, rather than to make the gifts outright. A transfer in trust may be preferred because the donee is a minor, the donor does not want the donee to obtain present control of the asset being transferred, the donor desires the ultimate benefit of the gift to pass to another, or the donor wants the trustee to be able to flexibly distribute the trusts benefits.[103]

The present interest requirement can prevent many transfers into trust from qualifying for the annual exclusion, in whole or in part, because the trust beneficiaries have only future interests or some part of their interest is a future interest. For example, if the terms of a trust provide that all distributions of income or of corpus are in the trustee's discretion, no beneficiary of the trust will have a present unrestricted right to use, possession or enjoyment of the property transferred to the trust. Thus, transfers to such a trust will not qualify for the annual exclusion. If the trustee must distribute all or some specified amount of the income to a beneficiary, the beneficiary does have an unrestricted right to enjoyment of that income and the present value of that income stream is a present interest, but other interests in the trust will not qualify for the annual exclusion. There are some transfers for the benefit of minors into trust, or into trust-like vehicles, that do qualify for the annual exclusion, so long as the property is made available to the minor at age twenty-one.[104]

> possess or enjoy the property. These terms are not words of art, like "fee" in the law of seizin ... but connote the right to substantial present economic benefit. The question is of *time*, not when title vests, but when *enjoyment begins.*

Id. (emphasis added).

103. The reasons for entrusting property for the benefit of a minor are obvious. There are various methods to qualify transfers into trusts for minors for the annual exclusion, as discussed infra notes 104-10 and accompanying text. The reasons for transferring property in trust for an adult are less obvious, but plentiful. The adult may be a poor manager of property. Alternatively, the adult may be a generally good manager of property, but perhaps took a business risk that turned out poorly and has creditors who would take the transferred property if it were given directly to the adult. The adult may be in poor health and need help managing the transferred property. The asset transferred may be stock of a closely-held business that the donor wants a hand-picked trustee, rather than one or more adult beneficiaries, to vote. The trust may be one used to avoid a generation-skipping transfer tax on the $1 million exempt amount (IRC § 2631(a)) and so may provide for broad distribution authority among the transferor's descendants, yielding no present interest for any beneficiary. The potential reasons for creating a trust for an adult are thus numerous.

104. Congress recognized the problem of qualifying transfers to the benefit of minors as a present interest and added section 2503(c) to the Code in 1954. S. Rep. No. 1622, 83d Cong., 2d Sess. 127 (1954). Under it, a transfer in trust for a person under age 21 is not considered a future interest if the property and its income may be distributed for the benefit of the beneficiary before he attains age 21, and any amount not so expended is payable to the

While these methods can be helpful, none of them will be of use to a donor who does not desire to provide the donee a fixed income interest, to permit the donee to receive the property at age 21, or earlier, or to permit the donee to receive the property outright at any time. Such a donor must either forego claiming the annual exclusion or rely on withdrawal rights which are discussed below.

2. *Withdrawal Rights.*—As a means of satisfying the present interest requirement in connection with transfers in trust, taxpayers' advisors developed plans which gave the trust beneficiaries withdrawal rights with respect to property transferred to the trust.[105] The trust beneficiary or beneficiaries are granted a right, exercisable with respect to property transferred into the trust and for a limited period of time following the transfer, such as 30 days, to withdraw an amount equal to the lesser of: (i) a pro rata share of the property contributed to the trust; or (ii) the annual exclusion.[106] Such withdrawal rights give each beneficiary an unrestricted right, upon their demand, to use or enjoy the amount subject thereto.[107]

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beneficiary at age 21 or is subject to a general power if he dies before attaining age 21. IRC § 2503(c); Regs. § 25.2503-4. In addition, states have adopted statutes based on the Uniform Transfers to Minors Act and the Uniform Gifts to Minors Act. Uniform Transfers to Minors Act, Prefatory Note (Langbein and Waggoner, 1992). The minor for whose benefit a transfer is made under these provisions has the interest and rights in the property that satisfy the requirements of section 2503(c). Rev. Rul. 59-357, 1959-2 C.B. 212. Accordingly, transfers to custodianships created under these acts qualify for the annual exclusion where the age at which the custodial property must be paid over to the beneficiary is age 21 or less. Rev. Rul. 73-287, 1973-2 C.B. 321 (acknowledging that section 2503(c) establishes the maximum limits that may be imposed on a transfer to a minor without making the transfer a future interest, and recognizing that requiring the transfer of property from a custodian to a beneficiary at age 18, rather than age 21, is consistent with section 2503(c)).

105. Gilmore v. Commissioner, 213 F.2d 520 (6th Cir. 1954), is an early case dealing with withdrawal rights held by beneficiaries, indicating that practitioners early on made use of general powers in connection with use of the annual exclusion.

106. Sometimes another limitation on the withdrawal right is added to coordinate with section 2514(e). Under that section, the lapse of a withdrawal right would generally be considered a transfer by the person holding the right to the other beneficiaries of the trust involved. However, section 2514(e) states that the lapse of a withdrawal right will not be considered a transfer if the amount subject to withdrawal is no greater than $5,000 or five percent of the trust corpus. Hence, if it is desirable to prevent the beneficiary with the withdrawal right from being treated as having made a gift transfer of the amount subject to withdrawal upon the lapse of the right, then the amount subject to withdrawal is limited to $5,000 or five percent of the trust corpus.

107. Although exercisable only for 30 days, the right of a beneficiary to force the trustee to distribute the property to the beneficiary outright is a right to use or enjoy the property, the *sine qua non* of a present interest. Fondren v. Commissioner, 324 U.S. 18 (1945). Plainly, however, by limiting the right to 30 days, the donor of the property reduces the

These rights were quickly recognized to be sufficient to make a transfer to a trust qualify as a gift of a present interest. After a number of court cases addressing the issue, culminating in Crummey v. Commissioner,[108] it also became clear that withdrawal rights granted to a minor beneficiary of a trust would convert the minor's interest to a present interest.[109]

Hence, the withdrawal right gives the beneficiary a present interest in property, even where the beneficiary is a minor and must depend upon the appointment of a guardian on his or her behalf to exercise the withdrawal right. Withdrawal rights provided to contingent remainder beneficiaries have also been held to create a present interest, even though after the lapse of the withdrawal rights the remainder beneficiaries would almost certainly not directly benefit from the trust property.[110]

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opportunity the donee has to exercise it and probably reduces the likelihood of its use, since events that occur after the 30 days expire can not be taken into account by the donee in deciding whether to exercise the right or not and because the 30 day limit requires the donor to persuade the donee not to exercise the right for only a brief period.

108. 397 F.2d 82 (9th Cir. 1968).

109. Under *Crummey*, the withdrawal right provides a present interest if, under the applicable state law, the minor, or someone on behalf of the minor, has the right to demand the property from the trustee and a guardian of the property of the minor can be appointed to receive the amount to be withdrawn. 397 F.2d at 87. The Ninth Circuit rejected the two other primary approaches that had been developed in other cases. Id. at 88. One of these approaches treated the withdrawal right as providing a present interest if it were likely to be exercised in light of the totality of the circumstances. Stifel v. Commissioner, 197 F.2d 107 (2d Cir. 1952). The other approach held that where any restrictions on the ability to exercise a withdrawal right were due to the disabilities of a minor the restrictions should be disregarded. Kieckhefer v. Commissioner, 189 F.2d 118 (7th Cir. 1951). In Revenue Ruling 73-405, 1973-2 C.B. 321, the Service announced that it would not raise the present interest issue in connection with a minor holding a withdrawal right where there is "no impediment under the trust or local law to the appointment of a guardian and the minor donee has a right to demand distribution." Rev. Rul. 73-405, 1973-2 C.B. 321. Subsequently, the Service has sought to place some additional limits on *Crummey* rights (as such withdrawal rights have come to be known). In Revenue Ruling 81-7, the Service asserted that a *Crummey* right would not provide the beneficiary a present interest where the beneficiary had no knowledge of the right, or the amount of time in which the power could be exercised was unreasonably short, because such a right is illusory. The Service also attacked withdrawal rights held by remainder beneficiaries. See infra note 110 and accompanying text. Rev. Rul. 81-7 1981-1 C.B. 474. For a detailed discussion of the analysis used in this area, see 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, 656 (1987).

110. Estate of Cristofani v. Commissioner, 97 T.C. 74 (1991), acq. in result, 1992-1 C.B. 1, action on decision, 1992-09 (Mar. 23, 1992). The contingent remainder beneficiaries who held withdrawal rights were the donor's grandchildren. If the withdrawal rights were not exercised, none of the trust property would ever be distributed to the grandchildren, unless the donor's child who was the parent of the grandchildren happened to die before the donor, or within 120 days after the donor died. The Service argued that the contingent remainder

3. *Some Limited Observations on the Consequences of Recognizing That a Withdrawal Right Gives the Withdrawal Right Holder a Present Interest.*—As was expressly recognized in *Crummey*, withdrawal rights given to minors are not expected to be exercised.[111] It is probably true that most withdrawal right holders, whether minors or adults, are made aware that the donor would prefer that they not exercise their rights. While legally the holders can exercise such rights, generally they do not.[112] Typically, the donor is a parent or grandparent and the donee is willing to honor the expressed preference. An obvious, though usually unstated, pressure to abide by the donor's preference is present because the donee is generally aware that the donor can provide *or withhold* many additional benefits and that compliance with the donor's preference may be a requisite to obtaining those additional benefits. Thus, as a practical matter, a donor's preference that withdrawal rights not translate into current possession is normally realized.

Nonetheless, the granting of a withdrawal right to a trust beneficiary converts the beneficiary's interest in the amount subject to withdrawal into a present interest, thus permitting that amount to qualify for the annual

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beneficiaries did not have a present interest. The Service asserted that the donor, the grandmother of the remainder beneficiaries, did not intend to provide any benefit to her grandchildren and provided them withdrawal rights only to obtain the benefit of the annual exclusion. The Service pointed out that in *Crummey*, the withdrawal right holders were the ultimate primary beneficiaries of the trust, and upon their failure to exercise their withdrawal rights they would still benefit from the trust assets. The Tax Court rejected the Service's argument, finding that there was no understanding or agreement between the donor and her grandchildren that the grandchildren would not exercise their rights. The Tax Court concluded, on the basis of *Crummey* and other authority, that because the withdrawal rights were legally enforceable, they created a present interest in the property.

111. 397 F.2d at 87-88; Stephens, et al. supra note 3, at ¶ 9.04[3][f], n. 85. Withdrawal rights are often granted to the beneficiaries of trusts that are designed to hold insurance on the life of the grantor. See infra Part III C 1 b. If the beneficiaries of such trusts exercised their withdrawal rights, in many such trusts the trustee would not have sufficient funds to pay the insurance premiums and keep the policy in force.

112. For the withdrawal rights to be effective, they must be enforceable. Hence, if there were an agreement between the donor and the holders of the withdrawal rights that the rights would not be exercised, that would raise a substantial question as to the enforceability of the withdrawal rights. Heyen v. Commissioner, 945 F.2d 359 (10th Cir. 1991); See Cristofani, 97 T.C. at 77, 83; cf. Regs. § 20.2036-1(a).

Section 2036 requires inclusion in a decedent's gross estate of property which the decedent transferred during lifetime for less than full and adequate consideration and with respect to which the decedent retained a life estate or other specified benefits or controls for the remainder of his life. Under Regulations section 20.2036-1(a), the decedent is treated as having retained "[a]n interest or right ... if at the time of the transfer there was an understanding, express or implied, that the interest or right would later be conferred." Regs. § 20.2036-1(a). But the donor could express a preference that the withdrawal right not be exercised without seeking the beneficiary's *agreement*.

exclusion. Once the withdrawal right expires, usually thirty days after the transfer is made or the beneficiary is given notice of it, the property that had been subject to withdrawal remains in the trust and is governed by the trust terms the donor selected. Because the donor can control how property transferred into trust is used by selecting the trustee and the trust terms, withdrawal rights encourage use of the annual exclusion to make transfers of property in a way that does not really give the donee control, or ultimately any benefit in many instances.

C. *Current Uses of the Annual Exclusion*

The annual exclusion is now used in several ways to avoid the federal transfer tax system. First, it can be used directly and regularly to make significant transfers of wealth, outright or in trust.[113] The value of the annual exclusion is maximized under the commonly held view that annual exclusion gifts constitute a separate category of gifts, the size of which need not be diminished by normal family-type gifts made to the same donees within the same year.[114] Second, through use of withdrawal rights, as described above, the exclusion permits highly leveraged gifts of life insurance in trust.[115] Third, the annual exclusion also protects some transfers that are asserted to be for support, but which are not clearly outside the scope of the transfer tax system.[116] Finally, the annual exclusion serves the function Congress intended for it—the prevention of transfer tax consequences with respect to normal family, holiday and wedding gifts.

1. *Significant Wealth Transfers*

a. *Direct Gifts.*—By increasing the exclusion to $10,000/$20,000 a year, Congress opened the door for persons with substantial wealth to make very large transfers over time while effectively avoiding gift, estate, and even generation-skipping transfer tax on those transfers. Consider a family with three adult children; each child is married and has two children of his or her own. If the parents have sufficient wealth, each year they can transfer $240,000 to their children, the spouses of their children and their grandchildren. If the parents have a base of wealth sufficient to permit such transfers on a regular basis, it is virtually certain that

113. See infra Part III C 1 a.
114. See infra Part III C 1 c.
115. See infra Part III C 1 b.
116. See infra Part III C 2, 3.

the estate of the longest living parent would be taxable at fifty percent.[117] Thus, each set of annual gifts permits the family to avoid $120,000 of transfer taxes.[118] The gifts to the grandchildren, totalling $120,000 a year, may also avoid GSTT, thus saving another $60,000 in transfer taxes.[119]

Note that over ten years' time, the parents can transfer twice as much as the unified credit would otherwise protect from tax without using up any portion of the unified credit.[120] Under the same example, those who have such large estates that Congress has made the policy judgment to deny them the benefit of the unified credit by the imposition of the five percent add-on tax can use the annual exclusion to give away twice as much as the unified credit would permit with no transfer tax consequences at all.[121]

If the property given away under the annual exclusion is of a type that is subject to a valuation discount, such as a minority interest in a closely-held business, the potential for transferring wealth becomes much greater. For example, assume an individual is the controlling shareholder in a family-owned corporation and makes gifts of minority interests in the stock of the business to each of his children each year. The value of those stock gifts may be substantially discounted in recognition of the fact that the shares given do not permit the donee to control the business and the difficulty of marketing a noncontrolling interest in a stock not traded on a regular exchange.[122] The Tax Court has recognized discounts of as much as fifty percent on certain

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117. This rate is imposed on taxable transfers in excess of $2.5 million. IRC § 2001(c).

118. .50 (estate tax rate) x $240,000 (amount of gifts) = $120,000.

119. The transfers to the grandchildren will avoid GSTT if made outright. IRC §§ 2642(c)(1), (3). However, if the transfers are in trust, they can avoid GSTT only if various requirements are satisfied. IRC § 2642(c). The six grandchildren would receive $20,000 each ($10,000 from each donor grandparent). Since the GSTT is imposed at a flat 50%, the GSTT savings available is at least 50% of $120,000 or $60,000. In fact, since the payment of GSTT by the donor of a direct skip is itself considered an additional gift by the donor under section 2515, the savings from avoiding GSTT is possibly as much as $90,000 under these facts ($60,000 of GSTT and $30,000 of gift tax).

120. The unified credit protects $600,000 of property from tax. See IRC § 2016(a). Therefore, a husband and wife who plan properly can pass $1.2 million free of federal transfer tax. Ten years of split annual exclusion gifts to 12 people is $2.4 million, exactly twice as much.

121. As noted previously, section 2001(c)(3) imposes a five percent add-on tax to taxable transfers in excess of $10,000,000 and up to $18,340,000, which has the effect of eliminating the benefit of the unified credit and the lower estate tax brackets. However, the add-on tax would do nothing to reduce the benefit of the use of the annual exclusion. Consequently, a large annual exclusion is highly inconsistent with the policy that gave rise to the five percent add-on tax.

122. Rev. Rul. 93-12, 1993-7 I.R.B. 13; Stephens, et al. supra note 3, at ¶ 10.02[2][c].

types of closely-held business interests.[123] Nonetheless, if the stock that was the subject of the gift is later sold as a part of a sale of the entire business by the family, the person who holds the gift stock will be able to realize the full value of the stock without regard to its minority status. Accordingly, the value likely to be realized by the donee of such gifts legitimately valued at $10,000 at the time of the gift, can quickly become as much as $20,000, thus effectively doubling the benefit of the exclusion.

b. *Use of Withdrawal Rights and Life Insurance to Leverage the Annual Exclusion.*—With the recognition that withdrawal rights qualify gifts into trust for the annual exclusion, the door was opened to allow the annual exclusion to be used even when the donor does not want to give the donee permanent control of the gift. Withdrawal rights also permit the annual exclusion to be highly leveraged and to avoid gift tax, estate tax and GSTT on very large amounts through the purchase of life insurance. The technique used is to make transfers into trust of money subject to withdrawal rights and thereby qualify the transfers for the annual exclusion.[124] The beneficiaries do not withdraw the money and the trustee uses it to purchase insurance on the donor's life. The terms of the trust may provide that the trust assets, including any insurance proceeds, will be used to benefit the donor's spouse and descendants.[125]

So long as the amounts of cash placed in the trust qualify for the annual exclusion, there is no gift tax on these transfers. In addition, if the donor, who is the insured person, has no "incidents of ownership" with respect to the insurance, and the insurance is not payable to the insured's estate, the insurance proceeds will not be included in his or her gross estate for tax purposes.[126] If the trust terms do not require distribution of principal to the donor's spouse or children or provide the spouse or any child with a general power to appoint the property to themselves or their estates, the insurance proceeds received by the trust can also avoid estate tax in the estates of the donor's spouse and children.[127] If the donor allocates an

123. E.g., Estate of Andrews v. Commissioner, 79 T.C. 938 & n.1, 942, 957 (1982).

124. See supra Part III B 2.

125. Headrick v. Commissioner, 93 T.C. 171, aff'd, 918 F.2d 1263 (6th Cir. 1990); Leder v. Commissioner, 89 T.C. 235 (1987), aff'd, 893 F.2d 237 (10th Cir. 1989); Perry v. Commissioner, 59 T.C.M. (CCH) 65, T.C.M. (P-H) ¶ 90,123 (1990), aff'd, 927 F.2d 209 (5th Cir. 1991).

126. Cf. IRC § 2042 (providing for inclusion where decedent possessed incident of ownership); see also cases cited in note 125.

127. Section 2033 directs that a decedent's gross estate includes the value of all property to the extent of "the interest therein of the decedent at the time of his death." IRC § 2033. If a decedent has only a life estate in property, or is a beneficiary of lifetime distributions from a trust, the extent of his interest at death becomes zero and nothing is

amount of his $1 million GSTT exemption sufficient to cover the contributions of cash made to the trust to enable it to pay the insurance premiums, the insurance proceeds received by the trust can even pass to the donor's grandchildren without incurring GSTT.[128] Thus, for example, for the price of five or ten annual exclusions the donor might enable the trust to purchase life insurance with a face value of $1 million, $2 million or more, and the insurance proceeds can entirely escape transfer tax and income tax at the donor's generation. By using an amount of GSTT exemption equal to the premium payments, the donor can also enable the insurance proceeds to escape transfer tax as it passes to the benefit of younger generations.

c. *Supplemental Gifts.*—It seems virtually certain that the donors of full annual exclusion gifts do not neglect to give their children and grandchildren birthday gifts, holiday gifts, wedding presents and other gifts. This is not to suggest that the donors who can afford to make annual exclusion gifts necessarily intend to violate the law by making a full $10,000 gift and then also making normal birthday and holiday gifts. However, many probably do not consider birthday, holiday and wedding presents and other similar gifts made as something that the government would tax. That is, where the value of such normal and recurring gifts is within the range that persons of similar socioeconomic status give on such occasions, and the gifts are not of investment type assets, the donor may not view such transfers as gifts. Rather the donor may view such gifts as a normal family activity which

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included. Accordingly, if an insured person's spouse and children are made beneficiaries of the trust, but have no right to control or demand the trust principal, it will not be included in their estates for estate tax purposes.

128. An individual may allocate any portion of the $1 million exemption from GSTT to any transfer. IRC § 2631. Thus, a portion of the exemption could be allocated to each transfer made to the trust to enable it to pay premiums. If all the property transferred to a trust is exempt from GSTT, the appreciation that occurs with respect to that property is also exempt under subsections (a) and (b) of section 2642. Under section 2642(a), the amount of a trust's assets *subject to* GSTT is to be a ratio, which is determined by subtracting from 1 the "applicable fraction" for that trust. The applicable fraction is determined by using a numerator equal to the GSTT exemption allocated to the trust and a denominator equal to the value of the property transferred to the trust. Hence, if the exemption allocated is equal to the value of the property transferred, the applicable fraction is 1, and this would make the inclusion ratio 1-1, or zero, meaning none of the trust property would be subject to GSTT. Section 2642(b) directs that if the GSTT exemption is allocated to a gift on a timely filed gift tax return, the value of the transferred property for GSTT exemption allocation purposes is its value for gift tax purposes, which is its value on the date of transfer. IRC § 2512(a). Under section 2642(b), if the exemption is allocated to property transferred at death, the GSTT value of the property is its estate tax value, which is usually date of death value. IRC §§ 2031, 2032. There are a few exceptions to the valuation rules of section 2642(b) in section 2642(f), but the exceptions would generally be inapplicable to an irrevocable life insurance trust.

is so common and so unrelated to most taxable activities that there is nothing that suggests any tax event has occurred.

Gifts of relatively large amounts of investment assets on the other hand are more likely to cause the donor to consider whether such transfers have any tax consequences. If the taxpayer is told that there are tax consequences to transfers in excess of the annual exclusion, he or she might assume that the excess transfers referred to are transfers of investment assets. Even the very reference to "annual exclusion" gifts suggests they are a separate category of gifts, rather than one that includes gifts made upon recurring occasions and big events, like weddings.

Accordingly, it seems highly probable that many donors who take advantage of the annual exclusion to permit the transfer of family wealth, simultaneously make normal, recurring gifts. This activity is, of course, clearly inconsistent with the legislative history regarding the workings of the annual exclusion and with the gift tax laws.[129]

Notwithstanding that such practices are plainly inconsistent with the law, the reporting requirements regarding the annual exclusion make it easy for this "double dipping" to occur. First, any gift of $10,000 or less simply need not be reported[130] if it meets the other requirements of the annual exclusion discussed above.[131] Thus, no return is required to be filed of a full $10,000 annual exclusion gift, that, if reported, would suggest to the Service that the donor might be making full use of the annual exclusion to transfer wealth and also be making the normal, recurring gifts.[132] Where one spouse is making the gift and the other spouse agrees to gift split, then a return is required to reflect the gifts made and the agreement of both spouses to be treated as the donor of one-half of the property given by either in that calendar year.[133] Nonetheless, the returns that can be used to reflect the agreement merely list the type of property transferred, the date of the transfer, and the value of the property, and record the consent of the spouse not actually making any transfer.[134] The returns never raise the question of whether the taxpayer made holiday, birthday or wedding presents to any of

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129. See supra Part III A 1.

130. IRC § 6019(a)(1).

131. See supra Part III B.

132. If the donor erroneously believes that the annual exclusion applies to investment-type gifts under $10,000 per donee, and that the gift tax system does not apply at all to traditional gifts to family and friends at birthdays and holidays, then the donor would likely make both types of gifts and report nothing.

133. IRC § 2513; Regs. §§ 25.2513-1(c), -2.

134. Form 709, United States Gift (and Generation-Skipping Transfer) Tax Return [hereinafter Form 709]; Form 709-A, United States Short Form Gift Tax Return [hereinafter Form 709-A]. The donor(s) must describe how the value of the gifts was determined.

the same donees to whom the annual exclusion gifts were made.[135]

It is also easy to avoid the necessity of making the return that is required only to reflect gift splitting. Current law permits any amount of property to be transferred from one spouse to the other outright without there being any tax due and there is no reporting requirement for such transfers.[136] Although this is a quite reasonable rule with respect to transfers between spouses given the availability of the marital deduction, it does permit an individual who wishes to make a $20,000 annual exclusion gift to use his or her spouse as a conduit for $10,000 per donee, and thereby avoid the requirement of filing any return with respect to the annual gift.[137]

2. *Protecting Excessive Support Transfers Made to Persons to Whom a Legal Obligation of Support Exists.*—In general, transfers which satisfy an obligation of support imposed by state law should be excluded from the gift tax system.[138] While neither the Code nor the regulations expressly so provide, a transfer in satisfaction of a legal claim for support should be one for "full and adequate consideration."[139] Nonetheless, transfers which are

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135. See Form 709, supra note 134; Form 709-A, supra note 134. The directions to Form 709 do state that the gift tax does not apply to any gift where the gift is under $10,000 and is of a present interest, is a tuition or medical care gift, is to a political organization, or is to a spouse and meets certain additional criteria. Nonetheless, the simplicity of the instructions may work against the correct result. The directions do not specifically point out that holiday, birthday, wedding, graduation and other similar gifts count against the $10,000 limit. It is not difficult to imagine a taxpayer reading the instructions and concluding that gifts of the normal family variety are not taxable.

136. IRC §§ 2523, 6019(a)(2).

137. For example, assume a married couple where spouse A has substantially more property than spouse B. Further assume that they are both agreed that it would be desirable to make annual exclusion gifts of $20,000 to each of their children in the present year. A has two ways to accomplish this transfer. First, A can give $20,000 to each child and then report the gifts on a gift tax return permitting B to treat half of the gift as coming from B. Second, A can transfer $10,000 to B and then each spouse can make a $10,000 gift to each child. Under the latter approach, no gift tax return is required to be filed. If A gave $10,000 to B subject to an understanding or agreement that the donee spouse would give the property to the ultimate donee, the donee spouse should not be considered the owner and the gift should be considered as one from the first donor to the ultimate donee. Absent any enforceable arrangement between the spouses, however, it should not be possible to collapse these steps.

138. Boris I. Bittker & Lawrence Lokken, 5 Federal Taxation of Income, Estates and Gifts ¶ 121.4.3 (2d ed. 1993) [hereinafter Bittker & Lokken]; ALI Proposal, supra note 98; Stephens, et al. supra note 3, at ¶ 10.02[5]; cf. Id. at ¶ 4.15[1][d] n. 26 (discussing relinquishment of support rights of children as consideration, in context of section 2034(b)); Gutman, supra note 12, at 1240-49 (discussing administrative convenience rationale for exclusion for reasonable support expenditures and statutory exclusions of tuition and medical expenditures).

139. Bittker & Lokken, supra note 138; Stephens, et al. supra note 3, at ¶ 10.02[5];

for support can surely be so luxurious as to involve a gift element.[140]

To see how transfers meant as support can result in gifts, consider the situation of an accomplished couple who have built their family business into a great success. They have two children, ages thirteen and seventeen. Under the law of the state where they are domiciled, a parent is required to support a child up to the age of eighteen. Both the children live at home and all clothing, food, shelter and other such items are provided by the parents. The couple makes regular birthday gifts, holiday gifts and other occasional gifts to the children. In addition, the couple purchased an automobile for the seventeen-year old, that is titled in the name of the father or the mother but is always used by the child. The thirteen-year old regularly receives concert tickets, and was given a mountain bike. The children are taken on a family vacation during the summer and another at Christmas. The seventeen-year old also goes on a beach trip with several of her friends during the summer.

As described above, such transfers are, in some part, likely to be support required to be provided by state law and not reasonably considered gifts. In general, support is a variable concept that adjusts with the ability to pay.[141] Certainly, it is common and reasonable to permit a seventeen-year old to have the use of a car, which may reduce the transportation time load on the parents.[142] A bicycle can be a useful form of transportation for a teenager without a driver's license. Concerts are a common form of entertainment.

On the other hand, to some extent, support is also defined by what others who are similarly situated provide their children.[143] Suppose, for example, the automobiles provided by similarly situated families average $10,000-$15,000 in value and that the automobile provided by this family to the seventeen-year old is a $30,000 luxury car. Assume that the mountain

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cf. IRC § 2516 (acknowledging that property settlement payments made for support of minor children in divorce context are deemed to be for full and adequate consideration).

140. For example, the support of a child may include providing a winter coat. If, however, the coat is an extremely expensive designer original, its value may exceed any support obligation and the transfer may also be part gift.

141. 73 Am. Jur. 2d Support §§ 1, 11 (1974); 83 C.J.S. Support (1953). See also, David Beck & Sheldon V. Ekman, Where Does Support End and Taxable Gift Begin? 23 Inst. on Fed. Tax'n 1181 (1965).

142. It seems reasonable to think that expenditures which save the time of parents and allow them to produce a better level of support for the family may be support expenditures. Providing a car to a child to enable that child to transport himself or herself, and perhaps younger siblings, may free the parents to work more, become involved in school governance affairs, spend time on political matters or take other steps to support the family and better its situation.

143. For example, at one time an automobile was a luxury that few families owned. Now, automobiles are hardly luxuries, and driving by a high school parking lot in many parts of the country will convince one that many parents make them available to their children.

bikes provided by most families similarly situated cost $500 and the bike provided to the thirteen-year old is the hottest new model with a carbon fiber frame and the best suspension system that cost $2,500, and that the thirteen-year old gets another $1,000 worth of clothing and accessories. Imagine that the concert tickets are not the regular ones that sell for $35, but are $500 tickets that permit the holder to come backstage and meet the performers.

With respect to the vacations, assume that the average family in the same economic situation as our hypothetical family spends an additional $5,000 to take the kids with them on the summer and Christmas vacations, while our hypothetical family spends an additional $12,000 to take the kids to England in the summer and Aspen in the winter. Let us also assume that the seventeen-year old uses the family beach house for her summer escapade with her friends and the house rental is normally $2,200 a week during the summer.

Under existing gift tax law, there is some gift element in each of these transfers. If the parents in our hypothetical family have not otherwise used their annual exclusions with respect to the children, the gift elements in these transfers are probably fully protected by the $10,000/$20,000 annual exclusion. However, if the parents have made use of their annual exclusions to make gifts of stock in the family business to the children or into trusts for them, then, under current law, one set of gifts should be reported and some of the parents' unified credit consumed. Again, as noted above, given the reporting required with respect to annual exclusion gifts, and the view of annual exclusion gifts as somehow separate, such additional gifts are no more likely to be reported than are the birthday and holiday gifts made by persons who have fully used the annual exclusion to make gifts of stock or land or of some other major family asset.

Again, this is not to suggest that the donors are intentionally breaking the law; they probably believe that if they are providing their children the same lifestyle as they enjoy, then the transfers are for support, not luxuries which include a gift element. Even if the parents are apprised of the gift nature of some part of the transfers made to the children, they may reject that advice as a mere technicality, not a law the government would ever enforce. They may be right, and it is certainly undesirable for the government to get in the business of determining which transfers parents make to their minor children are for support.[144] However, given the likelihood that wealthy parents make support-type transfers which in fact have a gift element in them and also make additional gifts under the annual exclusion, it is reasonable to limit the annual exclusion so that both types of wealth transfer do not escape

144. For a more detailed discussion of why consumptive transfers for support of minors are not a significant transfer tax system concern, see Part V C.

taxation.

3. *Protecting Support Type Transfers Made to Persons to Whom the Transferor Has No Obligation of Support.*—Suppose our hypothetical couple's children have now attained ages nineteen and twenty-three, and that under the applicable law the parents have no obligation to support children over the age of eighteen. The nineteen-year old is now in college and the twenty-three-year old is in graduate school. The parents pay the tuition for each directly to the appropriate school, thus qualifying those payments for the tuition exclusion of section 2503(e). However, the parents also provide each child an apartment, utilities, food, a car and insurance for the car, as well as plane tickets home for some occasions. They also still take each child on vacation and allow each to use the family beach house for a week each summer.

Because there is no legal obligation to make any such payments, each such payment (other than the excluded tuition) is a gift.[145] If the annual exclusions with respect to these children are not otherwise used, most of these gifts are probably protected from transfer tax. However, if the annual exclusions are being fully or even partially used to make stock gifts, then current law requires that these other gifts be reported and that the consumption of some unified credit by the donors be acknowledged. Even if the annual exclusion is not being otherwise used to make stock gifts, it is not difficult to conclude, given the expense of some educational programs and the related housing and living expenses, that some of those persons supporting adult students are in fact making gifts that exceed the annual exclusion level and that should be reported.[146] Again, given the reporting system and the sense that such transfers are for support and are at least pursuant to a moral duty, it is very unlikely such transfers are often reported, even if full annual exclusion gifts are also made to the same donee.

Under existing law a similar problem can arise from providing

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145. In some states, such as Georgia, the support obligation still ends at the age of majority. E.g., Still v. Still, 405 S.E.2d 762 (Ga. 1991); Ritchea v. Ritchea, 260 S.E.2d 871 (Ga. 1979); Coleman v. Coleman, 240 S.E.2d 870 (Ga. 1977); Clavin v. Clavin, 238 Ga. 421 (1977); Crane v. Crane, 170 S.E.2d 392 (Ga. 1969). Other states follow a different rule, and may impose obligations on nondivorced parents to pay for post-secondary education of adult children. See generally Jack W. Zitter, Annotation, Post-Secondary Education as Within Nondivorced Parent & Child-Support Obligations, 42 A.L.R. 4th 819 (1985 & Supp. 1992).

146. This would be particularly true where the parent paying the education expenses is a single parent who is limited to a $10,000 annual exclusion per child, rather than the effective $20,000 per child exclusion available when both parents make the transfer. Even when both parents are involved, if one actually provides all the value transferred and it exceeds $10,000, they are violating the law if they fail to file a gift tax return and consent to split the gift amount. See discussion supra note 59.

support for adult persons who, for example, are in a home for the aged or who live in their own home but need assistance to do so. Section 2503(e) permits an exclusion from gift tax for transfers made for the medical care (as defined in section 213(d)) of another, so long as the payment is made to the care provider. The regulations under section 213(d) state that where an individual is in an institution, and his condition is such that the availability of medical care in such institution is not a principal reason for his presence there, only the actual medical care costs, if any, are considered a medical care expense.[147] Expenses of lodging and meals are *not* considered part of the medical care in that situation.[148] Thus, if a person is in a home for the aged or a nursing home, but needs little if any medical care, the lodging expenses and meal expenses paid by another will not qualify for the section 2503(e) exclusion. Similarly, where a care provider who is not a nurse or other medical care provider is paid to stay in the home with an aged person, the expense will not qualify for the medical care gift exclusion. The same would be true of expenses for most retirement communities where many of the residents are not there for medical care. Such transfers would qualify for the annual exclusion, to the extent they are present interests (and most would be), but the exclusion may not be large enough to protect all such transfers.

4. *Protecting Normal Gifts From Tax and Reporting.*—For many persons who do not make large gifts and who do not or can not provide support that contains a gift element, the annual exclusion continues to serve the role envisioned for it by Congress—protecting normal birthday, holiday and other regular gifts from tax and from having to be reported.

5. *Summation of Current Uses.*—As the foregoing demonstrates, the actual functions of the annual exclusion include: (i) the direct transfer of significant amounts of wealth; (ii) the indirect transfer of even greater amounts of wealth in connection with life insurance trusts; (iii) the transfer of additional amounts indirectly because of the absence of reporting requirements and a sense that annual exclusion gifts are a separate category; (iv) the protection from tax of transfers that are intended as support but exceed any reasonable support standard; (v) the protection from tax of transfers for support purposes made to adults to whom no legal obligation of support is owed, but to whom the donor may feel a moral obligation; and (vi) the protection of normal, recurring gifts made by family and friends from gift tax consequences.

147. Regs. § 1.213-1(e)(1)(v)(b).
148. Id.

IV. PROBLEMS WITH THE ANNUAL EXCLUSION UNDER ITS PRESENT DESIGN AND GIVEN ITS CURRENT USES

A. *Makes Avoidance of the Transfer Tax System Easy*

The annual exclusion is serving a variety of functions in addition to its express purpose of protecting normal family and friend-type gifts from taxation and reporting. The exclusion is so large, and the gift tax reporting requirements so vague, as to permit wealthy persons to make large scale wealth transfers over time with no transfer tax consequences.

Through the unified credit, the system already provides the equivalent of a $600,000 exemption, which can generate a $1.2 million exemption for married couples who are well advised.[149] The system also provides that if the amount of wealth transferred is over $10 million, a five percent add-on tax applies, thereby denying the transferor the benefit of the $600,000 exemption equivalent.[150] Nevertheless, because the annual exclusion is so large and is renewed annually, it can permit wealth transfers greater than the unified credit in appropriate circumstances. The desire to permit support-type transfers to be made without fear of gift tax consequences, whether such transfers are made pursuant to a legal obligation or only a moral duty of support, understandably pressured Congress to make the annual exclusion large enough to obviate such fears. However, in doing so, Congress opened the door to large wealth transfers by wealthy persons. *Conversely, the annual exclusion is so small as to fail to protect from gift tax consequences some support-type transfers made to adults whom the donors are not obligated to support, such as adult children in school or elderly family members needing care that is not "medical."*

It is inconsistent with the historical development of the annual exclusion, the gift tax system, and the transfer tax system as a whole, to have a gift tax exclusion which permits large wealth transfers to be made tax free. It is particularly inappropriate to have such an exclusion in a gift tax system that fails to protect other transfers that do not and are not intended to avoid the wealth transfer tax system, such as payments for support of adult children or the aged, which are pursuant to a moral obligation and which generally *consume* the assets transferred.

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149. See supra note 31 and accompanying text.

150. IRC § 2001(c)(3). The add-on tax terminates after the exclusion equivalent has been recovered. See id.

B. *Vertical Inequity*

The existing annual exclusion directly promotes vertical inequity in the transfer tax system. The system is designed to impose tax on the wealthy. Like the income tax system, it is somewhat progressive, purporting to impose a higher tax burden as the amount of wealth transferred increases.[151] The annual exclusion permits this progressivity to be undercut, as is easily illustrated.

Assume two individuals, A and B. Each has survived a spouse and is now unmarried, each is age 65 and healthy, each is eligible for Medicare and receives some Social Security, and each has three adult children.

A owns property worth $1.4 million, as follows:

Principal Residence	--	$350,000
Vacation Residence	--	$150,000
Investments	--	$900,000

B owns property worth $5 million, as follows:

Principal Residence	--	$500,000
Vacation Residence	--	$300,000
Investments	--	$4,200,000

If A does not reduce his estate, at death the estate tax due will be $512,800, reduced by the $192,800 unified credit, for an actual payment of $320,000, or twenty-three percent of A's wealth.[152] Although A is eligible for Medicare and also receives Social Security, the burden of keeping up two homes, the worries about care that might be needed that Medicare does not provide, the desire to travel and enjoy retirement, all indicate A will not be in a position to make the type of regularly recurring substantial gifts needed to reduce his estate tax. In a few years, when he no longer wants both homes, A could sell one of them and that may permit A to make some gifts. However, it is most likely that A will retain the bulk of his wealth until his death because of a desire for security. Essentially, A is wealthy enough to be subject to the estate tax, but not so wealthy as to afford to make recurring

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151. Estate tax rates range from a low of 18% to a high of 50%. IRC § 2001(c)(1), (2)(D). Because the unified credit "pays" the tax on up to $600,000, the rates that actually apply range from 37% to 50%. IRC § 2001(c)(1).

152. The total of $1,400,000 would bear tax of $448,300 plus 43% of the excess over $1,250,000. ($448,300 + $64,500 = $512,800; $512,800 - $192,800 = $320,000.) For purposes of simplicity, we are ignoring the deductions available to the estate under section 2053.

annual exclusion gifts.

B's wealth is three-and-a-half times greater than A's. If B does not reduce his estate by gifts or other means, B's estate will pay tax, after subtracting the unified credit, of $2,083,000, which is nearly forty-two percent of his wealth.[153] The forty-two percent B's estate could pay is not far from a 100% increase over the twenty-four percent A's estate is likely to pay, reflecting some significant progressivity in the transfer tax system.

B, who is also eligible for Medicare and Social Security, and who has a much greater income producing ability than A, can afford to make regular annual exclusion gifts to his children and their spouses over the next many years, reducing his assets by $120,000 per year, or $1.8 million over fifteen years. Assuming he does so, he will die with an estate of $3.2 million, which (assuming it is all taxable) will incur tax of $1,183,000.[154] The proper percentage to use in comparison to A's twenty-four percent is determined by dividing B's estate tax due by $5 million, since that is the total amount he will transfer, counting both gifts and testamentary transfers. The percentage of tax his estate bears is now 23.66%, nearly identical to the 24% of A's wealth consumed by estate tax, even though the total wealth transferred by B is still three-and-a-half times that transferred by A.

Because of his ability to make large gifts each year, B, the wealthier taxpayer, can significantly reduce his estate tax burden while retaining ample assets to be assured of his comfortable support. The annual exclusion is a tool he can use to great effect. The less wealthy taxpayer is simply not in a position to make easy use of the annual exclusion. It makes no sense to have a provision that is intended as an administrative convenience but which in operation permits a wealthy taxpayer to avoid $900,000 of tax and to compromise the progressivity of the transfer tax system.

C. *Horizontal Inequity*

In addition to the vertical inequity illustrated above, the annual exclusion also contributes to and magnifies some horizontal inequities in the transfer tax system. This occurs principally in connection with transfers of interests in closely held businesses and life insurance.

To illustrate, assume taxpayers A and B each have assets worth $5 million. A's primary assets are a residence and publicly traded stocks and bonds. B's primary assets are a residence and a closely held business. Each

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153. See IRC § 2001(c). Note that prior to 1993, the tax on B's estate would have been somewhat higher, at $2,198,000.

154. Pre-1993, the tax on $3,200,000 would have been $1,025,800 plus 53% of the excess over $2,500,000 and 55% of the excess over $3,000,000. That is, $1,025,800 + $375,000 = $1,400,800. $1,400,800 - $192,800 = $1,208,000.

is married, has three children who are married, and each feels comfortable making full, split annual exclusion gifts to each child and each child's spouse. Thus, A gives $120,000 to his children and their spouses each year for five years, and so does B. However, because B gives stock in the closely held business, the stock is discounted from its pro rata value by one-third to one-half.[155] A gives publicly traded stocks and bonds, which are valued for gift tax purposes at market price.[156] After five years, during which neither the publicly traded stocks nor the privately held company appreciates, the children of A and B sell the stock, with the children of B participating in a complete sale of the business. A's children receive $600,000. B's children receive $900,000. A has $4.4 million left to pay tax on, while B has only $4.1 million. The sole difference is that B's family owned the entire company and sold the entire business. Thus, the recipients of B's gifts realized the full value of these gifts *and the premium* that is often paid for control of a healthy business, even though they did not own a controlling interest themselves. Although this might have happened to A's family, it is less likely where the gift stock is publicly traded, at least since the decline in the number of leveraged buy-outs and mergers. It is especially less likely if A held a fairly diversified portfolio and gave each child a "slice" thereof, since the likelihood that a controlling interest in several of the companies in the portfolio would be sold is slim.

Admittedly, the annual exclusion is not the root cause of the different results for the two families—valuation is. But, the annual exclusion is a tool that permits B to exploit the opportunity available to his family at *no* transfer tax cost. Differences in valuation of different types of assets may be appropriate, but substantially limiting the annual exclusion would at least make B pay tax (or use unified credit) to utilize to any significant extent the valuation advantage that the asset he owns provides.

A similar difference can arise among similarly situated taxpayers where one is insurable and another is not. As noted above, an insurable taxpayer can donate funds to an irrevocable trust, the trust can acquire the life insurance on the taxpayer, and the insurance can be excluded from the insured taxpayer's estate.[157] The funds given to the trust can qualify for the annual exclusion if the trust beneficiaries have withdrawal rights.[158] For

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155. A substantial minority interest discount for closely held stock based on lack of control and marketability is very common. John H. Bishop & Arthur H. Rosenbloom, Federal Tax Valuation Digest (1982).

156. Of course, the market price for small blocks of publicly traded stock already reflects the market's judgment about how much that stock's price should be reduced due to its lack of control.

157. See supra Part III C 1 b.

158. See supra Part III B 2.

purposes of comparison, assume that taxpayer A is insurable but taxpayer B is not. A makes transfers of $60,000 per year, for ten years, to a life insurance trust for the benefit of his children and spouse which transfers are protected from gift tax by the annual exclusion. The trust purchases a $12 million policy on A's life. B is not insurable. However, B also makes gifts to a trust of $60,000 per year, for ten years, and those transfers are also protected from gift tax by the annual exclusion. If A and B live long enough, and if the investments made of the $60,000 per year transferred by B are well handled, they could also grow into $12 million. But in the meantime, A's family has the assurance that if A dies the family will obtain instant "appreciation" while B's family will not have that assurance.

Again, the annual exclusion is not the immediate cause of the difference—the causes are the estate tax treatment of life insurance and the differences in the insurability of different taxpayers. But the annual exclusion, coupled with the use of withdrawal rights, is the tool that makes it easy for taxpayers to take advantage of these primary factors.

D. *Disrespect for the Law*

The annual exclusion, being as large as it is, teaches disrespect for the law to those who are subject to federal transfer tax and who learn something about that system and about the exclusion. Such taxpayers can quickly perceive the sizable loophole the exclusion represents and its inconsistency with the general thrust of the transfer tax system. Experience shows they are aware, for example, that the personal exemption from income tax is much smaller than $10,000.[159] They are further aware that the personal exemption against income tax phases out as income goes up,[160] while the annual exclusion does not phase out and, in fact, to a limited extent becomes more valuable as wealth increases.[161]

The element of the annual exclusion that seems to generate the most disrespect is the use of withdrawal rights based on *Crummey*.[162] Personal experience shows that once clients understand that the annual exclusion requires that the recipient have a present interest in the gift property, and then understand the general legal and practical operation of withdrawal rights, they

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159. The personal exemption from income tax is $2,000, adjusted for inflation from 1990. IRC § 151(d)(1), (4)(B). Of course, additional exemptions may be available to an individual taxpayer for a spouse and dependents. IRC § 151(b), (c).

160. IRC § 151(d)(3).

161. The annual exclusion becomes more valuable as taxable wealth increases to $2.5 million because under section 2001(c) the estate tax rate increases until the taxable estate reaches $2.5 million.

162. 397 F.2d 82 (9th Cir. 1968).

often laugh aloud at the silliness of the law. They can not believe that such an empty, formal analysis is followed, in light of the goals of the transfer tax system as a whole. Their greatest scorn is for the law's treatment of withdrawal rights given to minors where there is no genuine possibility that the withdrawal rights will be exercised. Nearly as laughable to them is the use of withdrawal rights to permit transfers into trust for the benefit of young adults to qualify for the annual exclusion, where the young adults are still dependent on the transferor for support and the transferor does not want the young adult to exercise the withdrawal rights. When clients who want to avoid paying estate tax laugh at the operation of a law that works in their favor, something is wrong.

Another reflection of the disrespect for the law which the annual exclusion generates can be seen in the *Heyen* case.[163] In *Heyen*, the taxpayer gave blocks of stock valued at less than $10,000 to each of twenty-nine persons. Twenty-seven of the twenty-nine "donees" signed blank stock certificates shortly after receiving the stock, so as to permit the stock to be reissued to members of the taxpayer's family. The evidence showed that the nonfamily recipients either agreed in advance to transfer the stock to members of the taxpayer's family, or did not know they were receiving a gift of stock and thought they were merely facilitating some stock transfers. The executor of the taxpayer's estate argued that the gifts to the nonfamily members were valid gifts, that the decision of those persons to make further gifts to members of the decedent's family were voluntary, and thus all transfers were protected by the annual exclusion. The Tenth Circuit found:

> The evidence at trial indicated the decedent intended to transfer the stock to her family rather than to the intermediate recipients. The intermediary recipients only received the stock certificates and signed them in blank so that the stock could be reissued to a member of decedent's family. Decedent merely used those recipients to create gift tax exclusions to avoid paying gift tax on indirect gifts to the actual family members.[164]

It is difficult to know how widespread *Heyen*-type activity is. The taxpayer in *Heyen* filed a gift tax return (presumably because additional gifts not within the annual exclusion were made in the same year), and following her death the return was audited, probably in connection with the audit of her estate. Had no gift tax return been filed, and had decedent's death occurred

163. Heyen v. United States, 945 F.2d 359 (10th Cir. 1991).

164. Id. at 363.

several years after the gifts, rather than nine months after, it is questionable whether her actions would have been discovered. The absence of a spate of such cases does not mean that numerous taxpayers have not used a similar approach and been luckier. The lure of large savings that use of multiple exclusions dangles before the taxpayer suggests many may have taken the bait and gotten away.

V. VARIOUS APPROACHES TO MODIFICATION

A. *Reasons to Retain and Modify*

The combined effect of the problems discussed above is sufficient to cause one to wonder whether the annual exclusion should be eliminated. If government intrusion and administrative concerns were not an issue, it might be most desirable to eliminate the exclusion. Its elimination would substantially reduce the opportunities of those persons who are targets of the transfer tax system to avoid its application and would also eliminate the other problems discussed above.

However, the original concerns of Congress regarding the reporting of small gifts are still present. From the taxpayer's perspective, there is a significant issue of governmental intrusion. Not every gift represents a transfer of wealth sufficiently substantial as to justify the imposition of obligations to report the transfer and pay tax thereon (or report the use of unified credit). Whether it is a wealthy person or a not so wealthy person who takes a friend to dinner to celebrate the friend's birthday or promotion, or other event, neither will likely be willing to tolerate a transfer tax system so severe that the dinner has to be reported on a gift tax return. The kindness of all those who would enliven the day of another by a simple generous gesture should not be clouded by concerns of reporting gifts and calculating credits, especially where no enduring transfer of wealth occurs.

In addition, the Internal Revenue Service has very limited resources to deal with the millions of tax returns it already receives each year.[165] If every transfer in excess of support, very broadly defined, were reported to the Service, either it would be hopelessly bogged down, or, as is more likely the case, would simply ignore the returns. Furthermore, many, if not most, taxpayers would probably ignore the return requirements. Also, defining "support" in the broad manner that would likely be required if the annual exclusion were eliminated would be very difficult and might permit

165. IRS Statistics Show Audit Rates Stable for Individuals, Increasing for Others, Daily Tax Rep. (BNA) No. 108, at (LEXIS) D7 (June 8, 1993) (reporting audit rates for individuals at 0.91% and most other rates around five percent or below).

significant untaxed wealth transfers to be made under the new system as easily as they are under the exclusion.[166]

Nonetheless, change is plainly needed. Congress did not acknowledge any change in the annual exclusion's purpose in 1981 when it increased the exclusion limit from $3,000/$6,000 to $10,000/$20,000.[167] Admittedly, the concerns about the gift taxation of transfers for education and medical care expressed at that time deserved some response and the increased exclusion may have been a part of that response. But, there are other responses that could be made which would not increase vertical inequity in the system or contribute to horizontal inequity.

If in 1981 Congress intended, without expressly saying so, to change the policy behind the annual exclusion away from the bases of administrative convenience and freedom from government intrusion, it was wrong to do so. There are other ways to permit support-type transfers to be made tax-free, as will be discussed below. Accordingly, there is no need to set the annual exclusion at a level intended to protect from tax support-type transfers to adult children and to the ill or infirm, but which also allows significant transfers of wealth having nothing to do with support. If the transfer tax burden is too heavy, Congress should change the transfer tax rate structure in an open, direct means of correcting the problem, rather than through an exclusion that some use, some could use but do not because they are not aware of it, and some can not use.

Taking into account the administrative need for some form of annual exclusion and the demonstrated problems with the current form, there is a preference for designing a system under which: (i) transfers for current support, which do not transfer lasting tangible wealth, are not required to be reported, even if made to persons who are not legally entitled to support; (ii) tax-free transfers that are not for current support are both limited and reported in a useful fashion; and (iii) administrative burdens on taxpayers and the government are not substantially increased. To satisfy these requirements, either "support" must be defined or its definition made unnecessary, and the ability to transfer wealth tax-free for purposes other than support should be substantially reduced.

In the sections following, three proposals made by others with respect to these matters are reviewed: (i) the first by the American Law Institute[168] and augmented by a related proposal by Professor Milton Ray;[169] (ii) the

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166. See infra notes 172-179 and accompanying text.

167. See supra Part III A 2.

168. ALI Proposal, supra note 98.

169. Milton Ray, The Transfer-for-Consumption Problem: Support and the Gift Tax, 59 Or. L. Rev. 425 (1981).

second by Harry L. Gutman;[170] (iii) and a third by a Task Force on Transfer Tax Restructuring established by the ABA Section of Taxation.[171] All of the proposals would, to some extent, permit transfers for support to be free of gift tax consequences, and would (except one) tighten up the annual exclusion. Each of the proposals has some merit, but each also has flaws. Following the discussion of these proposals is a discussion of my own proposal for achieving the goals set out above.

B. *Reviewing The Earlier Proposals*

1. *The ALI/Ray Model.*—Some years ago, the American Law Institute and other commentators suggested that transfers for support be excluded from the definition of gifts, and attempted to define "support" for this purpose.[172] The ALI proposal excluded from transfer tax any expenditure for the benefit of a resident of the transferor's household, or for the benefit of a minor child of the transferor (whether or not a resident of the household), provided that the expenditure did not result in the transferee obtaining property which would retain "significant value" after the passage of one year from the date of the expenditure. The ALI proposal also excluded all *current* educational, medical or dental expenditures for any person and the *current* costs of food, clothing and maintenance of living accommodations of anyone dependent on the transferor, provided the expenditure was "reasonable" in amount. The annual exclusion was left fully intact as a separate

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170. Harry L. Gutman, Reforming Federal Wealth Transfer Taxes After ERTA, 69 U. Va. L. Rev. 1183, 1244-49 (1983); Harry L. Gutman, A Comment on the ABA Tax Section Task Force Report On Transfer Tax Restructuring, 41 Tax Law. 653, 657-660 (1987) [hereinafter Gutman Comment].

171. Task Force on Transfer Tax Restructuring, ABA Section of Taxation, Report on Transfer Tax Restructuring, 41 Tax Law. 393 (1987) [hereinafter the Restructuring Report].

In addition to the three proposlas discussed herein, another recent proposal for reform of the annual exclusion was made by John G. Steinkamp, Common Sense and the Annual Exclusion, 72 Neb. L. Rev. 106 (1993). Steinkamp sharply criticizes the allowance of the annual exclusion for transfers of income interests, transfers of certain indirect outright gifts, and transfers subject to withdrawal rights that lapse if not exercised. He would allow the exclusion only for outright transfers and for transfers in trust where the trust benefits only one beneficiary and that beneficiary (or a guardian for the beneficiary) has a withdrawal right over all the trust property that does not lapse. He does not propose any modification of the tuition or medical care exclusions, nor does he propose an exclusion for support-type transfers made to adults. Instead he would rely on the annual exclusion to continue to protect such transfers from the gift tax. Id. at 171. He also proposes to index the exclusion for inflation. Since he does not propose expanding the exclusions for consumptive, support-related transfers as a means to limit the annual exclusion, his proposal is not discussed in detail here, but certain of his arguments are addressed in various footnotes infra.

172. ALI Proposal, supra note 98, at 19-21; Ray, supra note 169.

exception from gift tax under the ALI proposal.

The ALI proposal was also the basis of a more refined proposal made by Ray in a 1981 article.[173] Ray defined "significant value" (which the ALI had not attempted to define), to include the value of property transferred to the donee in one calendar year "which (property) will retain a value in excess of the amount of the annual exclusion ... at the end of the second calendar year following the close of the year of expenditure."[174] He expanded the persons to whom such transfers could be made to include not only any person in the transferor's household, but also any person as to whom the transferor could claim a dependency deduction and any person included in a large list of relatives.[175] His proposal also included the exclusion for current educational, medical and dental costs proposed by the ALI, as well as current food, clothing and living accommodation costs. While the annual exclusion would have been retained in section 2503(b), Ray's proposal would have denied a transferor who used his proposed new exclusions in a year the use of the annual exclusion in that same year.

Both of these proposals reflect: (i) a belief that transfers for "support" should not be a gift for tax purposes, even where the transfer is not one required pursuant to an obligation of support under local law; (ii) a recognition that many transfers made by parents to adult children for education in college and made to others, such as aged parents, for care, which can be viewed as transfers for support even though not required by state law, exceeded the $3,000 annual exclusion limit of the time; and (iii) a conclusion that it is inappropriate to have the law continue in a form that results in large scale violations of the law by those paying for their children's education and helping to pay for the care of others.[176] After concluding that state law was neither uniform nor clear in defining support, the ALI and Ray offered proposals that would establish a federal transfer tax definition of support—not

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173. Ray, supra note 169, at 446-50.

174. Id. at 449.

175. Id. Those as to whom a dependency exemption could be taken include any dependent (as defined in section 152) whose gross income for the year is less than the exemption amount, or who is the taxpayer's child and who is either under age 19 during the year or a student under age 24 during the year. "Dependent" is defined in section 152(a) to include the taxpayer's descendants, stepchildren, siblings and step-siblings, ancestors, stepparents, nephews and nieces, aunts and uncles, a broad range of in-laws, and members of the taxpayer's household. Ray's proposal would allow tax-free transfers to a person defined as a dependent by section 152(a), *regardless* of whether or not the taxpayer could claim an exemption with respect to that dependent.

176. All of these concerns are legitimate today, as has been demonstrated above. Transfers for support of adult children and aged parents may now exceed the $10,000 annual exclusion limit and thus place the donors under a return filing requirement, which is no doubt often ignored.

one that would govern for purposes of guiding the determination of support payments in the divorce context, but one determinative of whether any gift had been made that should be included in the tax system. Both proposals focused not on the transfer of wealth, which is the general focus of the transfer tax system, but on whether the transfer resulted in a build-up of wealth in the *transferee*.[177] Since Ray's proposal is more refined, it is examined here.

Several troublesome issues arise under Ray's proposal, as he recognized. For example, determination at the time of the transfer of whether an asset would have a value greater than the annual exclusion at the end of the second calendar year after the year of transfer would often be quite difficult. Because the proposal would permit such transfers to be made to a wide range of the transferor's relatives, including descendants, this form of transfer could in fact be used both to remove wealth from the donor and to build up wealth in the hands of the donee without any gift tax being incurred. For example, payment of the rent on a child's apartment or of an automobile lease payment arguably would not create wealth in the donee's hands and so would be excluded from gift tax by this proposal. But, by eliminating that expense for the donee, the donor allows the donee to build up his or her own wealth with savings equal to the amount the donee would otherwise pay on his or her own, and if such payments could be made without gift tax consequences, the donor could also reduce his or her own estate.[178]

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177. That both the ALI Proposal and Ray focus on the build-up of wealth in the *transferee* is revealed by their use of the "significant value" standard, which is measured by the value of the transferred property in the transferee's hands after the passage of one year (the ALI proposal) or two years (the Ray proposal), and the support type transfers their proposals would exempt from transfer tax. This approach seems contrary to that set forth in Regulations section 25.2511-2(a) (quoted supra note 2), which makes it plain that the tax is imposed on the value passing *from* the *donor*, not the enrichment of the *donee*. The regulation is entirely consistent with the measure of the value of property subject to estate tax. IRC §§ 2031, 2033. Given that the two systems are meant to complement each other, and that their purpose is to tax the *transfer*, not receipt, of wealth, it is entirely appropriate to focus the valuation function of the gift tax on what is transferred, not the value of the item in the hands of the recipient after the passage of some period of time. Nonetheless, as discussed in Part V C, it is probably appropriate in some circumstances to examine the value of the asset or benefit transferred shortly after the transfer to determine whether a transfer of wealth ever occurred. If the value transferred is consumed, as it would be in many of the support-type transfers, the ALI/Ray proposals would protect such value from transfer tax. Arguably in such case no transfer has occurred.

178. This fungibility aspect could be an interesting consideration in connection with any cash gift, but especially so where the gift is to be valued two years later. If, after the two years expire, the gift is valued at the amount of cash received, the gift will never exceed the exclusion amount assuming it did not exceed it at the time of the gift. However, suppose a cash gift of $9,000 is used by a dependent young adult to pay expenses and the payment

"Current educational" costs could also be too broad. To illustrate, most people would probably find a sailing trip around the world to be "educational" in some degree, but if someone else pays for such a trip should the transfer involved escape the transfer tax system?[179]

Another provision of Ray's proposal that would cause some problems would be the denial of use of the annual exclusion as to any donee with respect to whom the support exclusion were used in the same calendar year. The support exclusion would be the statutory basis for exempting from gift tax (i) any transfers which do not retain significant value at the end of the second calendar year after the year of the gift to any "person in fact dependent on the transferor," (ii) current educational, medical and dental costs, and (iii) food, living and accommodation costs. Hence, use of the support exclusion would certainly be required as to all minor children and many young adult children, thus preventing in that year the use of the annual exclusion to make other gifts, especially gifts that might appreciate in value. A person denied the use of the annual exclusion under Ray's proposal could make gifts of items that do not retain a value in excess of the annual exclusion after two years. But what if a person who is supporting a minor child also gives the child a piece of jewelry, some stock, or a parcel of real property that appreciates in value so that its value, combined with the value of any gift that did not retain significant value, exceeds the annual exclusion amount? Some limitation on the combined use of the support exclusion and the annual exclusion makes sense as to those who are sufficiently wealthy that the law should prevent them from avoiding the transfer tax system. However, this limitation makes little sense as to those who are very unlikely ever to have enough wealth to incur transfer tax, but who do have enough to make an occasional gift of an appreciating asset. They should not be put in the position of reporting such gifts or violating the law for failure to report them.

Further, while Ray's proposal would not permit use of both exclusions, it would permit the use of the full annual exclusion to protect gifts to those *not* receiving support transfers—such as emancipated children

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permits the young adult to retain some land inherited from his or her grandparents. In the two years after the cash is received, the property trebles in value. Should the gift, when being valued two years later, be viewed as the amount of cash, or the investment it preserved? Under current law, gifts are valued *when made* and it is the property transferred that is valued; hence, the issue is not as directly presented.

This fungibility aspect should play an important role in determining when transfers that occur through consumption of value for the benefit of another person should be treated as gifts. See infra Part V C.

179. If the focus is on whether the transfer builds up wealth in the donee, then perhaps not. However, as discussed supra note 177, the focus of the transfer tax is on the value transferred, not the wealth received or retained by the donee, and altering that focus can have significant consequences.

of the wealthy. Although at the time of his article and the ALI proposal the exclusion was only $3,000/$6,000, the current $10,000/$20,000 exclusion would permit the tax-free transfer of substantial wealth.

The approach embodied in the ALI's and Ray's proposals is laudable in some ways, because it seeks to separate "support" type transfers from "gift" type transfers, which would permit the law governing gift transfers to be designed without regard to support issues. The basic difficulty with both the ALI and Ray's proposals is that defining "support" is very difficult. The definition must remain somewhat flexible, since the concept of what is "support" varies depending on the ability of the supporter to provide and personal choices. Yet, it must not make it easy for persons to make transfers that are in fact gifts and hide them under the rubric of support. The ALI and Ray proposals satisfy the flexibility requirement. However, they are not well designed to prevent transfers of wealth.

2. *The Gutman Proposal.*—Another approach to limiting the annual exclusion has been offered by Harry L. Gutman.[180] His proposal would: (i) adopt a refined version of the ALI/Ray proposals;[181] (ii) deny the annual exclusion for any transfer in trust or to a custodianship; (iii) deny the annual exclusion for any transfer which requires an intermediary to record it (e.g., real estate, stocks, life insurance premium payments, etc.); (iv) set the exclusion level by reference to a "realistic appraisal of the aggregate value of incidental ... gifts an individual would be expected to make to a donee," suggesting at one point that perhaps $600 per donee might be appropriate[182]; and (v) measure the exclusion on a per donee basis (although a per transfer limitation might be considered).

A cornerstone of Gutman's proposal is the adoption of some version of the ALI/Ray proposals to exempt support related transfers from gift tax, which he acknowledges is an important step in permitting the reduction of the annual exclusion. Accordingly, the same arguments that support rejection of the ALI/Ray proposal could be asserted as a basis for rejecting the Gutman proposal. However, since the expanded tuition and medical care exclusions proposed in this article are meant to serve the same function as the ALI/Ray proposals—i.e., permitting the annual exclusion to be redesigned—the rest of the Gutman proposal deserves consideration.

The next two portions of the Gutman proposal are intended to help prevent transfers of certain types of assets under the annual exclusion.

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180. See Gutman, supra note 170.

181. Gutman does not specify the refinements necessary, although he does point out that transfers in trust would cause particular problems and cites to Ray's article. Gutman, supra note 170, at 1243 n.173.

182. Gutman Comment, supra note 170, at 658-60.

Denying the annual exclusion for transfers in trust or to a custodianship would serve as a disincentive to transfers where the donor does not wish the donee to have control of the asset. This might be particularly true of items of significant value or which play a role in controlling other assets, such as stock with special voting rights. Gutman's proposal to deny the exclusion for transfers of assets that require recording by an intermediary serves a related function; it would make it more difficult for donors to use the annual exclusion to give away certain types of assets, such as stocks, real estate, vehicles, and others, which the donee can not consume relatively quickly.[183] Thus, under Gutman's proposal the annual exclusion would also exist primarily to protect from taxation value that is consumed in the transfer or shortly thereafter.[184]

If the exclusion were set as low as $600 per donee, or any amount significantly lower than the existing exclusion level, the first question to answer is why other restraints on its use are necessary. Admittedly, some of the types of assets that could not be transferred under the annual exclusion if Gutman's proposal were adopted could normally be transferred at a discounted value, resulting in an effective increase in the annual exclusion. However, that cost does not seem worth limiting a donor's freedom to use a much smaller exclusion to transfer whatever type of asset the donor prefers.[185]

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183. Gutman also argues that if a transfer is made in trust or recordation is required with respect to the transfer, then the additional requirement of reporting the gift adds no great cost nor administrative burden. Gutman Comment, supra note 170, at 659. Gutman argues that since the reason for the exclusion is to eliminate the necessity of keeping account of small gifts, once someone is recording a gift it will be no real burden for it to be recorded twice, the second time on a gift tax return. This ignores that different persons may be recording the events. For example, a gift of stock is recorded on the books of the corporation, but the donor who would have to file a gift tax return under Gutman's approach may have no burden with respect to the first recording of the transfer, but now has a gift tax return to file. As a part of filing the return, the donor now must value that stock, whether it is publicly traded or closely held. Valuation of a corporation for the purpose of giving a small amount of stock to a child, where all would agree that the value of the stock is below the exclusion level seems burdensome. Nor is it easy to explain to a taxpayer why one person who makes a gift of a $500 item of jewelry does not have to file a return, but another who puts $500 in cash in a trust for a child or grandchild does.

184. Thus, Gutman states, "If not permitted for the transfer of ... assets [the transfer of which must be recorded by an intermediary], the exclusion would be available principally for cash, in-kind property transfers, and transfers of the use of property." Id.

185. The proposal for expanded tuition and medical care exclusions set forth in the text below includes restrictions on the types of assets that can be transferred since those exclusions are supposed to be available for only specific purposes and only where the assets transferred are to be consumed. The annual exclusion is supposed to be for wedding, holiday, birthday and other incidental gifts. Its purpose is thus much broader than the education and care related exclusions, and it is thus not appropriate to restrict the type of assets given under it. For a "Daddy Warbucks," giving "Little Orphan Annie" some stock for her birthday may

In addition, the limitation based on assets would seem to be relatively ineffective. So long as cash can be transferred under the exclusion, which Gutman clearly contemplates,[186] the donee (or a guardian acting for the donee) could purchase the assets that can not be transferred under the exclusion. If the donor/seller has a low basis in the assets, then obviously the sale could cause a gain to the seller. However, that would not be an issue where the donor/seller has a reasonably high basis. Further, the donee/buyer will have a higher basis due to the purchase, which will ultimately reduce the donee/buyer's gain on sale of the asset. Also, if the asset purchased is one that could be discounted for gift tax purposes, it could be discounted on the sale, so the donee/buyer could end up with just as much of that asset through purchasing it as could be transferred through a direct gift.

The proposal that no transfers in trust qualify for the annual exclusion seems too harsh and unnecessary given a substantial reduction in the amount of the annual exclusion. If any exclusion is permitted, it seems especially harsh to deny its use for transfers (even in the form of cash) to trusts or to custodianships. For example, consider a seventy-five-year old grandparent of a nineteen-year old child. Exclusions permitted for tuition and educational expenses incurred in the year of transfer will *not* allow that grandparent to help pay for the grandchild's later college or graduate school expenses if the grandparent dies while the child is a freshman in college. If the grandparent prefers to use the annual exclusion to build up funds in a trust for the child's education, which will prevent the funds from being squandered, instead of spending the exclusion amount on sweaters and shirts and such, there is no good reason that the grandparent should have to use his or her unified credit rather than the annual exclusion for such a transfer. A rational system should not encourage a grandparent to expend $600, or whatever exclusion amount is permitted, on things that will be quickly consumed, but discourage setting aside that amount for a child's education. An even more compelling argument can be made on behalf of a grandparent of a newborn grandchild, where the grandparent expects that he or she will not be around to use the tuition

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be as natural, and as appropriate, as it was for other parents to give their child a sweater. It seems extremely restrictive of the government to appear to be telling citizens what they can and can not give for birthday, wedding, graduation, Christmas and other holiday gifts. Of course, under Gutman's proposal, taxpayers would still be free to use their unified credit to make gifts of any assets they want. But the degree of government intrusion is very great when citizens are told they can give their children $600 in cash without filing a return, but not $600 worth of publicly traded stock.

186. Gutman's proposal that the exclusion be denied for all assets the transfer of which requires recordation by an intermediary could be viewed as denying the exclusion for transfers by check, which have to be recorded by the donee bank. Nonetheless, cash transfers are still eligible for the exclusion under his proposal, as reflected in the quotation in note 184 supra.

exclusion when the grandchild reaches college age. We should not restrict the grandparent to choosing bikes, baseball bats and Barbie dolls for birthday and Christmas presents, when the grandparent thinks it is appropriate to use the exclusion to establish a trust for the grandchild's education or to help the grandchild start a business.

Further, there are other ways to restrict a donee's control over assets transferred which Gutman's proposed restrictions on trusts would not deter. For example, limited partnerships, stock subject to shareholder agreements restricting its sale and other disposition, and nonvoting stock can all be used to transfer wealth without giving the donee control. Nor would Gutman's proposal to restrict the transfer under the annual exclusion of assets that require recordation prevent the use of these devices to restrict a donee's control, since in many cases cash could be transferred to the donee or the donee's guardian who could invest it in one or more assets subject to such devices.

Finally, if the $600 amount referenced by Gutman were adopted, the administrative burden would increase greatly.[187] Many people who now never exceed the $10,000 level, and would not exceed a much lower level of exclusion, would exceed a $600 per donee exclusion with some regularity. Many, if not most, engagement rings would have to be reported on gift tax returns, as would many suits of clothes, and many one time gifts (such as the really good bicycle, or the not so good used car, and the airline tickets home at Christmas or when somebody in the family dies).

While many of the particulars of Gutman's proposal are unacceptable for the reasons given, he makes an important point that requires attention in any effort to change the annual exclusion. He reminds us that the only reason that Congress has stated for allowing the annual exclusion is administrative simplicity.[188] If that is the reason for it, then, as Gutman points out, the dollar amount of the exclusion should be set by reference to a realistic

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187. A portion of Gutman's proposal, that dealing with assets requiring recordation by an intermediary, draws upon the notion that the administrative simplicity to be protected by the annual exclusion is the administrative simplicity of the taxpayer. First, an argument can be made that the administrative simplicity to be served is not that of the taxpayer, or at least not that of the taxpayer alone, but is that of the government, either primarily or at least substantially. A very small exclusion, and preventing the exclusion from being used as to certain assets, guarantees that the government will receive a very large number of new gift tax returns, many from people who would otherwise never file a transfer tax return of any kind. The government's resources, already stretched, would not wisely be spent dealing with returns reporting these types of transfers. Second, while his proposal would reduce the number of difficult to value assets that could be transferred under the exclusion (real estate, closely held stock, etc.), there could still be many kinds of such assets used to make exclusion gifts (e.g., jewelry, art work and collectibles). Thus, his approach would not prevent taxpayers from taking aggressive positions with respect to the value of gifts made under the exclusion.

188. Gutman Comment, supra note 170, at 658.

appraisal of the aggregate value of incidental type gifts an individual would expect to make to a single donee.[189] Gutman, however, does not describe how to identify the individual whose gifts should be appraised. If administrative simplicity is the goal, then the exclusion should be set at the level that will keep people who are not otherwise in the transfer tax system out of the system. People who are out of the system are those who have up to $600,000 of wealth ($1.2 million for married couples), because that is the amount of wealth that Congress permits to be transferred with no transfer tax. Accordingly, the dollar amount of the exclusion should be set at that amount which would cover the holiday, wedding, birthday and incidental gifts which persons with approximately that amount of wealth make on average to one donee, in a year when some larger types of gifts (e.g., wedding and graduation) are made.

3. *The Report on Transfer Tax Restructuring.*—A Task Force on Transfer Tax Restructuring was appointed in the mid-1980's by Hugh Calkins, who was then Chair of the Section of Taxation.[190] The Task Force's report recognized that the existing exclusion permits substantial transfer tax avoidance and suggested that it be revised by adopting an annual $30,000 per donor limit, and that the present interest requirement be replaced so that transfers in trust could qualify for the exclusion only if the transferred amount were for the benefit of a single beneficiary and would be includible in that beneficiary's gross estate to the extent not distributed to or for that beneficiary.[191] The Task Force recognized that any per donor limitation which substantially reduced the total amount transferable under the annual exclusion would make it more difficult to protect transfers for the support of emancipated adults from gift tax.[192] Accordingly, it suggested that the exclusion for tuition should be expanded to cover other educational expenses, but provided no detailed suggestions on how that might be done.[193] Further, the Task Force noted that the rationale for excluding payments of educational and medical expenses logically extends to other payments for support of nondependents, but concluded that the potential for abuse of an exclusion which extended to other support payments made such an exclusion infeasible.[194]

For reasons discussed in detail below, the Task Force's proposed per donor limitation is a desirable method of limiting the use of the annual exclusion to make large scale transfers of wealth. As the discussion of the

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189. Id. at 659.
190. The task force prepared the Restructuring Report, supra note 171.
191. Restructuring Report, supra note 171, at 401.
192. Id. at 402.
193. Id.
194. Id.

ALI/Ray proposals reflects, an exclusion for "support" is probably not workable. However, specific proposals for expansion of the tuition and medical care exclusions are set out below. The proposal to replace the present interest requirement with a "vesting" requirement is desirable for reasons discussed below.

The Task Force shied away from any recommendation about the amount of the per donee limitation, stating that the limits are political and economic issues. It may be that the per donee limit is a political and economic issue. However, if the political issue of why there should be an annual exclusion is settled, and the political and economic issue of who should escape the transfer tax system is settled (people with no more than $600,000), the determination of a per donee limit is reasonably determinable. Hence, the issue is one that can be empirically determined and it should be.

C. *Consumption Under the Transfer Tax System: A Key to the Analysis and Modification of the Tuition and Medical Care Exclusions*

1. *Introduction.*—A key to the ALI/Ray, Gutman and Task Force proposals is the view that the consumption of wealth for the benefit of another is not, in some instances at least, a transfer of wealth that ought to be subject to the transfer tax system. The ALI/Ray proposals reflect this overtly and in the type of transfers intended to be protected from gift tax. They would exempt expenditures for education, medical and dental care, food, clothing and living accommodations and any other expenditure that would not retain "significant value" after the passage of some specified period of time.[195] Gutman's proposal assumes that a refined version of the ALI/Ray proposals would be adopted and his proposal also accepts the premise that consumption for the benefit of another is, in some instances, a nontransfer for transfer tax purposes.[196] The Task Force proposal reflects the same view in its suggestion that the tuition exclusion be expanded, and the Task Force indicated that were it not for the abuse potential, it would favor extending the exclusion to all transfers for support.[197]

Consumption is also a key notion in the expanded tuition and medical care exclusions proposed below. Accordingly, it is useful to set forth the analytical basis for the exclusion from the transfer tax system of some consumption transfers. It is also important to set out the keys in determining which consumption transfers are to be excluded, for not all such transfers should be excluded from the transfer tax system.

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195. Ray expressly discusses consumption as the basis for the exclusions he supports. Ray, supra note 169, at 448.

196. Gutman, supra note 170, at 1243 n.173.

197. Restructuring Report, supra note 171, at 401-402.

2. *Consumption Viewed Through the Purpose of the Transfer Tax System.*—Determining whether consumption should be an exception to the transfer tax system, and, if it is, defining it for purposes of the exception, is first governed by the purposes of the transfer tax system. The basic purposes of the transfer tax system are to break up concentrations of wealth and to generate revenue. Taken to its extreme, a person's consumption of his or her own wealth could be taken into account in calculating how much transfer tax should be imposed on that person. For example, assume that a person spends several thousand dollars over a weekend to take the Concorde to Paris, where he or she eats and drinks very well, sees some expensive shows, and, when all is done, has nothing material to show for the expenditure. Obviously, a transfer of wealth has occurred, albeit one for full and adequate consideration. It could be asserted that it is appropriate to impose a tax in connection with such a transfer on the premise that anyone who can spend so much and get nothing material in return probably has a remaining accumulation of wealth which should be taxed. Certainly, if the consumption of one's own wealth were to be viewed as an event that should trigger the imposition of transfer tax, consumption for the benefit of another, where the value obtained on account of the expenditure made is conferred on another and the wealthy person gets nothing in return, should be viewed as a transfer subject to transfer tax.

However, Congress has not taken its efforts to break up concentrations of wealth through the transfer tax system so far as to tax a person on the consumption of his own wealth.[198] Instead, the transfer tax scheme that Congress has adopted applies only to transfers *to others* for *less* than full and adequate consideration.[199] Hence, the existing transfer tax system breaks up concentrations of wealth by taxing transfers made to others without consideration.

Consumption for oneself is, thus, not a taxable event for transfer tax purposes, because the wealthy person gets value back for that given and also, through consumption, contributes to the breaking up of his or her own wealth. Plainly, this does not mean that consumption for the benefit of another is outside the scope of the transfer tax system. Consumption for the benefit of another undeniably involves a transfer to another for less than full consideration. For example, if, out of friendship, X pays for Y to take the Paris trip described above, X has transferred to Y a benefit equivalent to the cash value of Y's expenses and has gotten no benefit in return that could be

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198. Certainly, there are various taxes that are more likely to affect a wealthy person than others, such as the excise taxes imposed on the purchase of luxury automobiles, boats, planes, jewelry and furs. IRC §§ 4001-4007. However, these taxes require the purchase of a specific item, not the general consumption of wealth described in the example.

199. See supra note 1 and accompanying text.

described as having a market value.

3. *When Consumption for Another's Benefit Should Be Viewed as a Transfer for Transfer Tax Purposes.*—Under what circumstances, then, if any, should consumption for the benefit of another be treated as excludible from the transfer tax system? In the proposals reviewed above, the factors that are used to determine whether consumption for the benefit of another should be treated as a transfer subject to transfer tax are: (i) the relationship of the donor and the donee (dependent minor children, residents of the household, persons who are described in section 152); (ii) the purpose of the consumption (education, medical care, dental care, food, living accommodations, etc.); (iii) the nature of the asset or assets, if any, acquired as a part of the consumption (items that will not retain a significant value one or two years after the transfer); and (iv) the amount involved (the "significant value" limitation set out in Ray's proposal).

There is one factor not specifically identified in any of the other proposals, but which relates each of these four factors. That factor is whether the person for whose benefit the consumption occurs is currently able, on account of the transfer inherent in the consumption, to save or make other use of some significant portion of the amount expended on the consumption. This is a key factor in determining when consumption for the benefit of another should be subject to transfer tax.

That it is a key factor can be demonstrated by considering the underlying reason for excluding from the transfer tax system any consumption for the benefit of another. The transfer tax system is designed to impose a tax on the *transfer* of wealth. While the tax due is measured on the basis of the value given up by the donor, *there must be a transfer* for the tax to apply. The basis for treating consumption for the benefit of another as not a transfer tax event is that nothing of material value exists within some short period after the expenditure occurs; it is as if no transfer occurred.[200] Accordingly, if substance is to prevail over form, the transfer tax should not apply because the wealth is gone—consumed—not transferred. However, *if the donee is*

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200. Gutman makes reference to this analysis where he states, "Others would assert that although transferees derive benefit from such payments, the payments are more properly viewed as consumption by the transferor with the result that no 'transfer' has occurred." Gutman, supra note 170, at 1241, n.168. Although this statement was made in the context of a discussion of transfers in satisfaction of an *obligation* of support, the same analysis would seem applicable to consumptive transfers that are not in satisfaction of an obligation as well. While it can be argued that a transfer occurred and should be treated as though the donor gave cash to the donee, who then consumed the cash in whatever expenditure actually occurred, this argument ignores the most essential point. Whether the donor or donee is viewed as expending the value, that value is *gone* and should, therefore, escape the transfer tax system because there was no lasting transfer.

thereby enabled, at some point in time reasonably close to the time of the transfer, to accumulate or make other use of his or her own wealth because of the transfer, then there has been a lasting transfer of wealth to which the transfer tax system should apply.

Each of the four factors listed above, relationship of donor and donee, purpose of transfer, assets acquired, and amount transferred, can be justified on the basis that they frequently, alone or in combination, provide some information about the probability that the beneficiary of the consumption is likely to be able to save or make some other use of some significant amount on account of the consumption for his or her benefit. None of the four is a very precise analytical tool, but they are probably the best that can be done and keep the law administrable.

For example, the descriptive relationship between a donor and donee may appropriately be considered in deciding whether to exempt a consumptive transfer for the benefit of the donee. It is reasonable to assume that minors do not have other resources they control, and therefore a minor donee is unlikely to be able to use the consumptive transfer to allow him or her to save some amount of his or her own wealth. Hence, where a consumptive transfer for the benefit of a minor child occurs, there is usually real consumption of the wealth.[201]

This argument is less compelling when the donee is an adult. In such case, there is a much greater chance that the consumptive transfer will permit the donee to accumulate wealth of his or her own. Accordingly, greater restrictions on what appear to be consumptive transfers in favor of adults are appropriate.

The purposes of a consumptive transfer may also affect the judgment of whether the transfer will result in accumulation of wealth. For example, it is probably true that most students, even those in graduate and post-graduate programs, are unlikely to accumulate wealth on account of consumptive transfers for their benefit. Accordingly, it may be appropriate to adopt a relatively simple general rule that consumptive transfers related to education are to be excluded, even though some donees will be able to accumulate wealth on account of such tranfers. The same may be true for transfers to help the elderly or ill persons.

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201. This analysis would, of course, help support the decision to ignore for federal transfer tax purposes transfers made to minor children pursuant to an obligation of support.

There may be an indirect general exception to the conclusion that a consumptive transfer for the benefit of a minor results in the real consumption of wealth. Where someone other than a parent of the minor is the donor, the *parents* of the donee may be afforded an opportunity to accumulate wealth. However, this should not be a very serious problem, as surely most consumptive transfers occur between parents and their children and between spouses.

If an asset is acquired in connection with a consumptive transfer, the useful life of the asset acquired also may be indicative of whether the transfer will permit the donee to accumulate wealth. For example, where an airline ticket is acquired and used, nothing remains in the hands of the donee. Hence, if the donee is not in a position to accumulate wealth at the time of, or shortly after, the flight, it is unlikely the donee will actually accumulate wealth on account of the consumptive transfer. If, on the other hand, the asset given is a long lived one, the chances that a transfer may occur are probably enhanced. For example, assume that an exclusion for student expenses includes transportation expenses. If this permits the transfer of an automobile to a student, and the student graduates one year after receiving an automobile as a gift, it is possible that the automobile's usefulness will last long enough to permit the donee to accumulate some wealth. Hence, in general, the longer lasting the asset, the greater the risk that it will permit the accumulation of wealth by the donee.[202] If, on the other hand, it is relatively likely that the value of the asset will reduce to zero during the period the donee is unlikely to accumulate wealth, then an expenditure to acquire that asset can be viewed as consumption.

The amount of the consumption will also affect the likelihood that the donee will be able to accumulate an amount of wealth on account of the consumptive transfer that is worthy of concern under the transfer tax system. If the donee is not a minor, and the purpose of the transfer is not one that suggests an accumulation is unlikely, then it is reasonable to restrict more severely the amount of the transfer that is excluded.

Plainly, the analysis of how likely a donee is to accumulate wealth on account of any given consumptive transfer could best be made in light of the most specific set of facts regarding the donee and the expenditure made. For example, an exclusion for education related transfers could be made more precise if each student who has other resources that could be used to pay education expenses (such as a trust established by the student's grandparent) were identified and the exclusion was denied for transfers to such students. But just as plainly, a generally applicable legal system can not deal with that degree of specifics and remain administrable when there are as many consumptive transfers as occur in the United States. Thus, relatively broad exceptions to the transfer tax system should be drawn for consumptive transfers using the rough tools listed above to reduce the risk that such

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202. Obviously, it can be argued that education can be one of the longest lasting assets and, accordingly, transfers for it should not be viewed as consumption. One response to this is that education is valued so highly that its long-lived nature is intentionally ignored for these purposes. Instead, the focus is on the fact that the donee has nothing tangible of great material value if all that has been paid for is tuition, supplies, food, clothing, housing (but not a house), transportation (but not ownership of a vehicle), and books.

transfers will permit the donees to accumulate wealth.[203]

D. *Liberalizing the Tuition and Medical Care Exclusions*

Present law provides unlimited tuition and medical care exclusions for amounts paid to the educational institution or the medical care provider. While these exclusions are helpful in protecting support-related, consumption-type transfers to persons the donor has no legal obligation to support and should be retained, they are inadequate to make certain that such transfers do not trigger the transfer tax system. The tuition exclusion falls short in failing to exclude from the transfer tax system payments for housing, books, supplies, food, clothing and transportation for students. The medical care exclusion falls short in failing to exclude nonmedical need care for the aged, such as providing for companions, paying for housing in a community for the aged where medical care is available but is not the primary reason the person resides in the community, food, clothing and transportation.

If these exclusions were expanded, the largest consumptive transfers related to another's support made by most taxpayers, including the support of adults, would be protected from transfer tax consequences. It would be unnecessary for donors to rely on the annual exclusion to protect such transfers from gift tax consequences.[204] Accordingly, the annual exclusion

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203. Another factor that might help assess whether a consumptive transfer permits the beneficiary to accumulate wealth is to determine if the donee would have otherwise consumed that amount. For example, consider the situation where X pays for Y's flight to Paris and an extravagant weekend. If Y would not have expended Y's own funds to take any such trip or make any replacement expenditure, the expenditures by X does not permit Y to save funds Y would otherwise have spent. However, there is no easy way to determine whether Y would have made such an expenditure if X did not. An objective test, based on the assets available to Y, or a subjective test, based on Y's intent to take such a trip, would have to be used to assess this factor. The objective test would be very complex, and the subjective test seems unreliable. Hence, this factor is unusable.

204. The Restructuring Report suggested that the tuition exclusion be expanded to cover other items related to education, but did not attempt to provide any detailed suggestions on how to accomplish the expansion. Restructuring Report, supra note 171, at 402.

It may be argued that if all states eventually impose an obligation on parents who have the financial ability to do so to provide post-secondary and even graduate school education to their children, no expansion of the tuition exclusion is necessary, since transfers in satisfaction of obligations to support are not subjected to transfer tax. This argument fails for at least three reasons. First, not all states impose such an obligation and there is no guarantee that they will. See discussion supra note 145. If not all states do so, then it would be inappropriate to have a federal transfer tax system, which should apply uniformly, permitting transfers related to education of adult children to escape gift tax if made in a state that imposes an obligation to make such transfers, while taxing such transfers made by parents who feel a moral obligation to do so but who are domiciled in states that do not impose a legal obligation to provide such support. Second, even if all states did eventually impose such

could be revised without severely affecting support related transfers made to persons to whom the transferor does not have a legal duty of support.

Obviously, changing the tuition and medical care exclusions to permit additional transfers for the purposes described above could also open the door to abuses. For example, permitting gift tax free transfers for "housing" a student or an elderly person could mean purchasing and transferring to the donee a $300,000 home. "Transportation" could mean transferring a plane or an expensive car that most people would view as a significant gift. None of these assets is short lived, and the amount involved is relatively large. Hence, under the analysis of consumptive transfers set out above, neither should be protected from transfer tax. To prevent such potential abuses, payments of these expenses would have to be limited in ways relatively easy to check and to enforce. These limits will be designed based on the factors identified above as useful in limiting the use of consumptive transfers to make wealth transfers.

The expanded tuition exclusion could be stated as an exclusion for student living expenses which would apply to transfers for the expense categories listed above and made to persons who are enrolled in and attending at least half-time an educational institution (as defined in section 170(b)(1)(A)(ii)), and who are in good standing at the time the transfer is made. Having limited this exclusion to such students, it does not seem necessary to limit the use of this exclusion to donors and donees within a particular set of relationships, so long as the purpose for which the transfer can be made, the amount of the transfer, and the types of assets acquired are reasonably limited.[205]

The amount of this exclusion could be subject to a dual cap, the

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an obligation, it is not at all certain they would impose it with respect to children who graduate from college or graduate school, are emancipated for several years, and then return to school. Hence, some exclusion would need to be available for such returning students. Third, if states can eliminate gift tax consequences by changing their support standards, what will prevent them from largely eliminating the gift tax for their wealthy citizens by requiring those that can, to provide their children, even adult children, all the necessaries and comforts they can provide consistent with their wealth, and without regard to the ability of the child to support himself or herself? In such a situation a federal standard to govern and limit such transfers would have to be developed or the federal transfer tax system would be severely breached.

205. While the exclusion could be limited to children, grandchildren, nieces, nephews, etc., there seems little reason to impose such a limitation. Most such transfers will undoubtedly occur intra-family. Nonetheless, if someone wants to pay the educational expenses of an unrelated person, there is no greater reason to tax that transfer than to tax an intra-family transfer of the same kind, given the other safeguards recommended. Note that while the relationship of the donor and donee is not defined, a similar limitation on the exclusion is achieved by requiring that the donee must be at least a half-time student enrolled in an educational institution.

lesser of expenses actually incurred or a specified dollar amount.[206] The specified dollar amount could be fixed in relation to the average expenses incurred for housing, transportation, food, clothing, books and supplies at relatively expensive institutions. The exclusion would be unavailable for expenses paid or reimbursed from any other source, such as other family members, a trust or a scholarship.

To prevent some major opportunities for exploitation, the statute should not protect the transfer of ownership of any real property or any tangible asset with a value in excess of a specified dollar amount, although it should allow the use of such assets. This should help prevent the transfer of long lasting assets under this exclusion. Additionally, transfers would be limited to those amounts and assets necessary for the *current* school year. To make the valuation of the transferred items easier, transfers could qualify for the exclusion only if made in cash or in the form of the item to be used (e.g., a book). The ultimate limit on the use of this exclusion would be that it could not be used as to any one donee for more than twice the number of years that a full-time student would require to obtain the degree sought by the donee.

While it would be possible to tighten up the safeguards against abuse of such an exclusion by providing that only payments made to vendors could qualify for the exclusion, that would add such a substantial amount of complexity that it does not seem desirable.[207] However, a reasonable additional safeguard against abuses of this exclusion would be to require the taxpayer claiming it to report that transfers had (or had not) been made in reliance on the exclusion, to list the social security numbers and relationships of all persons to whom such transfers had been made, and to retain receipts, canceled checks, or other records documenting the amounts transferred in reliance on the exclusion.[208] The law would also specify that taxpayers whose income tax returns are examined can also be required to produce this documentation. This could substantially reduce the number of those who would attempt to abuse the student living expense exclusion, and there would be no additional returns required to burden taxpayers or the Internal Revenue Service.

A similar approach could be taken with respect to expenses of caring

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206. Since the tuition exclusion itself would remain in place, the dollar amount limit need not encompass tuition too. The dollar amount limit should be indexed to the Consumer Price Index.

207. For example, paying the vendor directly for books, for gasoline for the student's vehicle, for groceries, or for food at the fast food restaurant, would all be difficult compared to paying tuition directly. While it could be accomplished in many cases with a parent-paid credit card in the hands of the student, that is not always feasible nor desirable.

208. This report could be made on a special schedule attached to the taxpayer's income tax return, but easily detached and transferred within the Internal Revenue Service to those having expertise in gift matters.

for the aged or others who need nonmedical care. The basic approach would be to permit transfers for housing, wages of caretakers to whom payments would not qualify for the medical care exclusion, food, clothing and transportation to be made free of gift tax, if made to pay or reimburse payment of expenses actually incurred and not paid from any other source. Like the student expense exclusion, this exclusion should place an annual cap on the transfers equal to the lesser of the amount actually required or a specified dollar amount. The specified amount should be related to the expense of a good home for the aged (which should be large enough to encompass food and a caretaker for those living at home), clothing and transportation. In addition, the transfers should be in the form of cash or the property to be used, and transfer of the ownership of real estate and any tangible asset with a value in excess of a stated dollar amount would be prohibited. Reporting could be handled in the same manner described above. Unlike the student expense exclusion, there would be no limit on the number of years that such transfers could be made, since there is no accurate method of predicting how long they will be required.

The likelihood of this exclusion being abused to transfer substantial wealth to transferees who are significantly older than the transferor might seem minimal, and one might wonder if any safeguards are required in this context. Generally, an older transferee could be expected to predecease the transferor. Accordingly, wealth transferred to an older transferee could be expected to be subjected to estate tax in the transferee's hands at an earlier date than it would have been in the transferor's hands, and thus one might expect such transfers would only be made if necessary and if the wealth will be consumed. However, safeguards are nonetheless desirable because of the unified credit and the GSTT exemption. If a wealthy person has an aged parent who needs care and who does not have enough assets to use his or her unified credit or GSTT exemption fully, or has just enough assets to use the unified credit, the parent's credit or exemption may provide the wealthy child an opportunity. If gift tax free transfers could be made to the parent under the expanded care exclusion which permitted the parent to accumulate or retain wealth to use his or her unified credit or GSTT exemption, this wealth could be left to the transferor's children or grandchildren without incurring transfer tax in either the parent's estate or the wealthy child's estate.

To minimize this risk effectively would probably mean requiring that the person to whom the transfer is made be a person of reasonably limited means, who must actually consume the transferred assets. Also required would be some documentation of the donee's status and the use of the transferred assets. Unfortunately, such requirements lead to the same type of detailed regulation found in the abominable Medicaid regulations which govern that program's payment of nursing home care and require proof of the

income and assets available to the recipient.[209] On balance, it is better to accept some potential abuse of this exclusion than to go down the labyrinthine path blazed by the Medicaid approach.

The potential abuse may not be that great. Many persons of wealth have parents and grandparents who already have sufficient assets to use the unified credit and GSTT exemption. Further, transfers under the exclusion must be outright to the donee or expended directly for his or her benefit. Hence, the donor will, in many cases, be taking a risk that the donee's accumulated wealth will be disposed of at the donee's death in some manner other than that which the donor expects. If the donee's will or other testamentary plan leaves his or her property to charity or to some branch of the family other than the donor's, the donor's plan may backfire. In addition, requiring that the donor and donee have some particular relationship in order to make use of this exclusion would prevent a *Heyen*-type use of this exclusion.[210]

If this exclusion is not limited to persons who bear a stated relationship to the donor, such as parent, grandparent, aunt, uncle, great-aunt or great-uncle, then it could be used to provide benefits to adult children or grandchildren of the donor who are in a position to accumulate wealth, or to nonfamily members who can be induced to accumulate wealth and leave it to the donor's family. For example, the donor could pay the apartment rent or automobile lease payment of an adult child, who in turn could accumulate that amount. On the other hand, if the persons to whom such transfers can be made are limited to a specified group, the potential for abuse is reduced, but donors then may not be able to claim the exclusion with respect to gifts to some deserving donees (e.g., the best friends of the donor's deceased parents, who were really the donor's primary care givers and who now need help paying for their expenses of living in a senior citizen's complex).

Given the potential for abuse, limiting the use of the exclusion to persons bearing one of the specified relationships to the donor listed above, or who are incompetent, is a reasonable course of action. By limiting the availability of this exclusion to the donor's parents, grandparents, aunts, uncles, great-aunts and great-uncles, the potential for using the exclusion to build up wealth in a large number of people who can be induced to leave it

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209. These regulations are very complex and quite harsh in limiting the amount of income and assets a person can have in order to qualify for public payment of nursing home costs. See, e.g., Joel C. Dobris, Medicaid Asset Planning by the Elderly: A Policy View of Expectations, Entitlement and Inheritance, 24 Real Prop., Prob. and Tr. J. 1 (Spring, 1989); Clifton B. Kruse, Jr., Discretionary Trusts: Insulating Trust Assets for Elders and Incapacitated Persons From Consideration by Medicaid and Other Public Support Providers, 17 Am. College of Trust and Estate Counsel Notes, No. 1 (Summer, 1991).

210. See supra notes 163-64 and accompanying text.

back to the donor's family is reduced. If incompetent persons are the only other donees who qualify under this exclusion, then the opportunity to use the exclusion to build up wealth in others, including children or grandchildren, is still reasonably limited. A person would be considered incompetent for this purpose if a court has found the person to be incompetent or if the donee's regularly attending physician has certified, in writing and under penalties of perjury, that the donee is incompetent. A copy of the court decision or the physician's certificate could be required to be filed with the return reporting the reliance on the exclusion.

E. *Modifications of the Annual Exclusion Considered*

Assuming that the changes proposed to the tuition and medical care exclusions are adopted, the annual exclusion could be modified in several direct and indirect ways. Several possible approaches to its modification are discussed below, followed by the selection of the modifications which will best accomplish the goals described in section A of this Part V.

1. *Reducing the Annual Exclusion Per Donee Limitation.*—A simple way to limit the use of the annual exclusion to avoid transfer tax is to reduce the amount of the exclusion, as Congress did in 1939 and 1942. It could be reduced from $10,000 per donee to the amount that persons with $600,000 of wealth give on average to a single donee for birthdays, holidays, weddings, graduation and such regularly occurring events as the annual exclusion was intended to cover. For purposes of discussion, an estimate of $5,000 will be used.

This is a very straightforward approach. If a taxpayer has only a few donees, it substantially reduces the amount of wealth the donor can transfer. Obviously, even if many donees are available to the taxpayer, such a reduction will cut the amount the taxpayer can transfer under the annual exclusion in half (assuming the $5,000 per donee limitation). However, if there are numerous donees available, the gross amount the taxpayer could give away during life, especially if married, might still amount to several hundred thousand dollars.

Moreover, a simple reduction in the amount of the exclusion may also affect some persons who are not targets of the wealth transfer system (generally, persons with a gross estate under $600,000), but who can afford to make occasional gifts in excess of $5,000, such as an automobile, furniture or a contribution toward the purchase of a home. The excess over $5,000 would be a taxable gift. Such excess would usually use up some unified credit, but would not require any out-of-pocket payment. However, the use of credit does require the filing of a gift tax return. Nonetheless, the number

of people affected should not be excessive.[211]

2. *Limiting the Amount That Can Be Transferred Under the Annual Exclusion in One Year by Any Single Donor.*—Another way to limit the use of the annual exclusion to avoid transfer tax would be to place a cap on the amount that a single donor could transfer under the exclusion in any one year.[212] For example, the annual exclusion might be limited to $10,000 per donee, as under current law, but each *donor's* transfers under the annual exclusion could be limited to $20,000 per year in the aggregate. Thus, if an individual had two children, he or she could, as under current law, give $10,000 to each of them. If the donor had four children, all of whom were married, and each of them had two children, the donor could still give as much as $10,000 to any one donee, but the aggregate gifts the donor could make under the annual exclusion to the children, their spouses and the grandchildren would be limited to $20,000, instead of $160,000 as under current law.

This approach, implemented without any reduction in the per donee limitation, would prevent the use of the annual exclusion to make the type of large wealth transfers described above, where the donor has numerous donees available.[213] However, under this approach, a donor with only a couple of

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211. See infra note 214.

Steinkamp, supra note 171, at 170-72, would leave the size of the exclusion unchanged, but would index it for inflation. However, under his approach the exclusion would still function to protect support related transfers to adults from gift tax, and thus could not reasonably be reduced in amount. However, by choosing that approach, Steinkamp leaves the exclusion at a size he acknowledges permits substantial wealth transfers. Id. at 169-170. He believes that replacing the present interest requirement with a provision which denies the exclusion for transfers of future interests, and permits transfers in trust to qualify for the exclusion only if the trust benefits a single beneficiary and the beneficiary (or a guardian) must have a nonlapsing withdrawal right, will prevent the exclusion from causing serious leakage in the transfer tax system. This ignores the practical controls donors of wealth can exercise over donees (e.g., "Use the withdrawal right and you will never see another penny"), and the types of assets that can be given outright but leave the donor in control, such as family partnership interests, nonvoting stock, stock subject to shareholder agreements, fractional interests in land, and other such assets.

212. I originally thought about a per donor limitation several years ago while in practice. It occurred to me after having tried to explain to a client the differences between the income and gift tax consequences of *Crummey* rights. I realized that the per donor limitation could be made the sole limitation, eliminating the per donee limit and, with it, the present interest requirement and the use of *Crummey* rights. The Restructuring Report, supra note 171, at 401, which I later read, suggested that a per donor limitation be adopted together with a replacement for the "present interest" requirement and a $100 de minimis per donee exclusion that would permit tax free and reporting free transfers of small amounts to other donees even after the donor had fully consumed the overall per year limit.

213. See supra Part III C 1 a.

donees could transfer the same amount of wealth as he or she can transfer under current law. Thus, a married couple with two children could, over 10 years, give $400,000 to the children under current law *and* under this proposal.

This approach is unlikely to cause very many persons who are not targets of the wealth transfer system to file any gift tax returns they do not have to file now, since it leaves the per donee limitation at $10,000 per person. Thus, it is perhaps less likely than the straightforward reduction in the per donee limit to increase the reporting burden on those who are not targets of the system.

3. *Reducing the Annual Exclusion Available Based on the Accumulated Use of Significant Amounts of Annual Exclusion.*—A somewhat different type of mechanism that could be used to prevent the use of the annual exclusion to transfer large amounts of property would be to reduce the annual exclusion available to those who make frequent and substantial use of it. This could be accomplished as follows: (i) leave the per donee annual exclusion limit at $10,000 and require each taxpayer to report gifts made to a single donee within a year that, in the aggregate, exceed a smaller stated dollar amount, such as $5,000; (ii) if the taxpayer reports in the aggregate such gifts totalling more than $30,000, or some other specified amount, then the taxpayer's annual exclusion would be reduced, prospectively, to $5,000 per donee; and (iii) if the taxpayer's aggregate reported gifts over $5,000 exceed $50,000, the taxpayer's annual exclusion would be reduced to $2,500 per donee.

Compared to present law, this system would require additional reporting, in that under current law an individual can give $10,000 per donee without reporting the gift. However, the number of people who make gifts in excess of $5,000 to any donee in a year, *assuming* expanded tuition and medical care exclusions, should be fairly small.[214] Hence, the number of

214. The number of gift tax returns (Forms 709) received in 1990 was 147,700, with a projected decline in 1991 to 143,800. Selected Historical Data, 10 Statistics of Income Bulletin 53, 87 (Winter 1990-1991). However, the number of gift tax returns projected to be filed in 1998 is 207,000. Bonnie L. Nichols, Projections of Returns to Be Filed in Fiscal Years 1991-1998, 10 Statistics of Income Bulletin 47, 52 (Winter 1990-1991). Since the reference in the bulletin is to Form 709, this should mean that the reports made, and estimated to be made in the future, were of taxable gifts. (However, if the reference to Form 709 in the bulletin includes the 709 Short Form, which can be used by spouses who split gifts that are within their combined annual exclusion, then even some of these returns may have reported, or may be expected to report, nontaxable gifts.) Reducing the exclusion to $5,000 may increase the number of returns several fold. But some significant amount of the increase that might otherwise occur should be eliminated by the liberalization of the tuition and medical care exclusions. Further, some number of those who now choose to make annual exclusion gifts

additional individuals required to file returns and the amount of time the IRS would have to devote to them should not be overwhelming. Further, merely exceeding the $5,000 per donee, per year limit would not trigger any immediate tax payment obligation. It would simply require the taxpayer to start reporting and recording the cumulative total of gifts made in excess of $5,000, whether under the annual exclusion or taxable, with a prospective reduction in that taxpayer's annual exclusion once the cumulative reported amount exceeds $30,000 and a further reduction when the reported cumulative total exceeds $50,000.

This approach has the benefit of reducing the benefit of the annual exclusion for those who are likely, ultimately, to owe some substantial amount of transfer tax and who should not be permitted to avoid the transfer tax system, while retaining the benefit of the exclusion to others. Compared to the present annual exclusion, this approach does add the complexity of a cumulative recordkeeping system for transfers in excess of $5,000, rather than $10,000. However, the burden would be primarily on taxpayers, rather than the IRS, and the burden should not be particularly heavy even for taxpayers.[215]

4. *The Present Interest Requirement.*—As discussed in Part III B, under existing law a transfer qualifies for the annual exclusion only if it is a transfer of a present interest.[216] Outright gifts and transfers to custodianships established under the Uniform Gifts to Minors Act (UGMA) or the Uniform Transfers to Minors Act (UTMA) also qualify.[217] Transfers to trusts which have the terms specified in section 2503(c) of the Code also qualify for the annual exclusion. The custodianships and section 2503(c) trusts essentially guarantee a minor who is the donee of a gift that he or she is the only person who can benefit from the transferred property and that he or she will either receive the property or at least have the opportunity to obtain full control of it on or before attaining age twenty-one.[218]

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up to the $10,000 limit, and who might add to the number of people who have to file returns if they continued making such gifts after the adoption of a smaller limit, would likely reduce the gifts they make to equal the smaller limit and thus not make gifts that have to be reported. Hence, even if the reduction in the annual exclusion limit would by itself increase the number of returns five-fold, for example, the countervailing factors should keep the increase to a factor much smaller than that.

215. Cumulative gift tax reporting is required under current law for gifts that are taxable. IRC § 2502.

216. See supra Part III B 1, 2.

217. See supra note 104.

218. The custodians of transfers made under either UGMA or UTMA are obligated to distribute the custodianship assets to the person for whose benefit the custodianship was created at age 21, although some enacting states have opted for age 18. UTMA § 20(1) (1991);

Another method of qualifying transfers for the annual exclusion under current law is to provide the beneficiary a withdrawal right with respect to property transferred to a trust. Permitting withdrawal rights to qualify gifts into trust for the annual exclusion is a farce, since it has been widely recognized that such rights are not likely to be exercised.[219]

The present interest requirement could be altered in at least three ways, each of which would have some impact on the use of the annual exclusion. It could be eliminated, so that gifts could qualify for the annual exclusion even if they are gifts of future interests. Second, it could be replaced with a provision under which transfers could only qualify for the annual exclusion if made outright or to a trust for one beneficiary, the terms of which force the property to be included in the beneficiary's gross estate to the extent it is not distributed to or for the benefit of that beneficiary.[220] Third, it could be altered so that its requirements can be satisfied *only* by outright transfers.[221]

Some guidance as to which is the appropriate approach may be provided by the legislative history underlying the present interest requirement. That history states that the present interest requirement was adopted to simplify the valuation of interests as to which the exclusion could be claimed.[222] That is, the present interest requirement prevented any claim that the annual exclusion applied to remote or contingent future interests which are very difficult to value and the donee of which is difficult to identify.[223]

If the primary intent behind the present interest requirement was to make valuation of the transferred interest easier, this goal could be achieved by any of the three approaches. For example, if the law were changed and a $20,000 per donor cap were placed on the annual exclusion, transfers could

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D.C. Code Ann. § 21-320 (1992); La. Rev. Stat. Ann. § 770 (West 1992); Okla. Stat. tit. 58, § 1221 (1992); R.I. Gen. Laws § 18-7-21 (1992). Code section 2503(c) and its regulations require that the trust beneficiary receive all remaining trust property upon attaining age 21. IRC § 2503(c)(2)(A); Regs. § 25.2503-4(a)(2). Regulations section 25.2503-4(b)(3) permits the *beneficiary* to extend the trust, but nonetheless the beneficiary must have a right to receive the trust property at age 21.

219. See supra notes 111-112 and accompanying text.

220. This was recommended in page 401 of the Restructuring Report, supra note 171.

221. Implicitly, this would eliminate *Crummey* withdrawal rights as a means for qualifying for the exclusion. Gutman has proposed that no transfer in trust qualify for the annual exclusion. Gutman, supra note 170, at 1245. For reasons discussed above (see supra pp. 415-16), that approach is too harsh.

222. S. Rep. No. 665, 72d Cong., 1st Sess. 41 (1932), reprinted in 1939-1 (Part 2) C.B. 496, 525.

223. Id.

be made under the annual exclusion without regard to whether any present interest existed in any donee and without regard to how many persons shared an interest in the amount transferred, so long as the donor retained no interest in the transferred property or any such retained interest was disregarded in determining how much of the exclusion the gift consumed.[224] Of course, this would entail giving up a per donee limit on the exclusion. That is because without a present interest requirement, as to many transfers in trust, numerous assumptions and calculations would be necessary to value the interest of each trust beneficiary. For example, if a trust receives a gift of $20,000, and the trustee is permitted to make discretionary distributions of corpus among multiple beneficiaries, valuing one beneficiary's interest would require numerous assumptions to be made about the value of his or her interest.

Permitting the annual exclusion for transfers in trust only if the trust has a single beneficiary and requires the property to be included in the beneficiary's gross estate to the extent not paid to or for that beneficiary serves the goal of easy valuation that the present interest requirement was designed to serve. This "vesting" approach also permits the use of both a per donee and a per donor limitation on the exclusion. Such transfers would be just as easy to value as those made under a per donor cap alone.

Finally, if only outright transfers qualified for the annual exclusion, the valuation obviously would not involve calculating the value of the interests of different beneficiaries, as there could never be more than one recipient of any one gift. Again, the valuation purpose of the present interest requirement would be served.

5. *The Amount of the Annual Exclusion for Married Couples.*—Under current law, each member of a married couple has available a full annual exclusion. If A and B are married and A does not have the resources to utilize the annual exclusion, B can make a gift to a third person of up to twice the amount of the exclusion. If A consents, the gift will be treated as using both A's and B's exclusion.[225]

A simple way to reduce the power of the annual exclusion to transfer wealth is to limit each member of a married couple to an annual exclusion

224. There is already precedent for ignoring the value of a retained interest when determining the value of the interest transferred. Section 2701 deals with valuation of equity interests and, sometimes, in valuing a business interest given away, directs that the value of an interest retained by the transferor in the same business be ignored. Section 2702 directs that the value of income interests retained by transferors of remainder interests be ignored in valuing the property given away, with the result that the transferor can be taxed as though the gift was not of only the remainder but of the entire property.

225. See supra note 59 and accompanying text.

that is one-half of the exclusion available to a single person. Although gift-splitting by spouses would still be permitted under this approach, the total amount a married couple could give any one donee would be limited to the amount a single person could give that donee.

6. *Gift Tax Reporting.*—An additional change that could be made to help control the use of the annual exclusion would be to revise the gift tax forms and directions to make it clear that *all* gifts reduce the exclusion. A reference to the gift tax reporting requirements could also be included in the income tax return and its directions, explaining that the annual exclusion is available but also explaining that *all* gifts, including those for birthdays, holidays, weddings, graduations and all such events, use up the exclusion.

F. *Implementing the Most Effective and Administrable Modifications to Address the Problems of the Current Annual Exclusion*

1. *Choosing Among the Most Direct Modifications.*—Of the six possible changes discussed above, those that would most directly affect the annual exclusion are: (i) reducing the per donee limitation in all cases (the "per donee" model); (ii) limiting the exclusion on a per donor basis (the "per donor" model); and (iii) reducing the annual exclusion based on cumulative use made thereof (the "cumulative use" model). Because these possible changes have the greatest potential impact on the exclusion their relative merits are discussed first. Thereafter, the other three proposed modifications are discussed and suggestions made as to which of them to implement.

Each of these possible modifications has its strengths and weaknesses when adjudged against the goals earlier identified for any changes to the annual exclusion.[226] The per donee and cumulative use models would cause all taxpayers making gifts in excess of $5,000[227] to any one donee to have

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226. See supra p. 408.

One of the persons who commented on this article pointed out that transfers under the annual exclusion (or even larger gifts) could be viewed as transfers that help break up concentrations of wealth, and, thus, should be encouraged rather than discouraged or taxed. Obviously, this approach is inconsistent with the revenue raising purpose of the transfer tax system and could be rejected on that basis. However, there is also a policy basis for rejecting that approach. The justification for taxing concentrations of wealth as they are transferred from the owner is to support the progressivity of the income tax system. Gutman, supra note 170, at 1212-16. By permitting gifts to break up the wealth without it being taxed, this progressivity function is compromised.

227. The $5,000 amount has no magical qualities, other than the fact that it represents a substantial reduction in the current level of the exclusion. The amount selected should be determined by studying the incidental gift level of those Congress has chosen to exempt from the transfer tax system through the unified credit.

to report those gifts, and, under the cumulative use model, gifts over $2,500 would have to be reported by some taxpayers. Thus, more taxpayers would likely file gift tax returns under these approaches than under the current $10,000 annual exclusion, and the returns would have to be processed by the government. The cumulative use model would require taxpayers to keep cumulative records of gifts over $5,000 per donee in order to determine when they have exceeded the $30,000 or $50,000 gift levels that trigger reductions in the annual exclusion. The per donee model would also require cumulative, lifetime reporting of gifts over $5,000 per donee, because under that model the excess over $5,000 would either consume some of the donor's unified credit or would actually cause gift tax to be due if the donor's credit had previously been consumed. While current law also requires cumulative reporting of gifts, because the exclusion is $10,000 per donee, fewer people are likely to have to report.

The per donor model (assuming no change in the $10,000 per donee model) would not so clearly increase the number of gift tax returns filed and the number of taxpayers required to involve themselves with a cumulative reporting system. Since it does not reduce the per donee limitation, it would not increase the number of returns required from any set of persons who never give over $10,000 to one donee and over $20,000 in a year. Most persons who can make gifts in a year of more than that amount (or over $40,000 in a year for a married donor) are almost certainly wealthy enough to be justifiably caught up in the transfer tax system and its reporting requirements. Thus, purely from an administrability viewpoint, the per donor model may have advantages vis-a-vis the other models that are likely to increase the amount of gift tax reporting by a somewhat larger number of persons. If a per donor model were adopted and the per donee limit were eliminated, the annual exclusion would be made quite simple. However, since such a per donor model would likely have to be established at a limit high enough to accommodate donors with multiple donees, such as $20,000, donors with only one or two donees would be able to transfer as much or more wealth as they can transfer now under the exclusion.

As to which of the models would be most effective in curtailing the use of the annual exclusion to transfer significant amounts of wealth, it seems likely the answer will vary, depending upon: (i) the number of potential donees the donor has; (ii) whether the donor is willing and able to make a gift of a large amount under the unified credit (up to $600,000); (iii) if the large gift is made, whether the property given appreciates or not; and (iv) if the large gift is made and appreciates, at what rate does it appreciate. The following examples will illustrate some of the variations.

First, assume a taxpayer who: (i) has five potential donees; (ii) can afford to make lifetime gifts up to $50,000 under the annual exclusion; (iii) thereafter, can afford to make annual gifts of $5,000 per donee; and

(iv) can not afford to make a large gift under the unified credit. After giving up to $50,000, this taxpayer will be able to make $25,000 worth of tax-free gifts annually under the cumulative use model, which is more than the taxpayer could give under the per donor model, which limits such gifts to $20,000 per year. The total transferred is also more than could be transferred tax free under the per donee model, which does not permit *any* $10,000 gifts before reducing the exclusion to $5,000.

Now, consider a taxpayer with five donees who can afford to make lifetime gifts of $50,000 under the annual exclusion and $600,000 under the unified credit. The additional $600,000 gift would, under the cumulative use model, cause the taxpayer's annual exclusion to be reduced to $2,500 per donee. Hence, the taxpayer loses the ability to get $12,500 (5 x $2,500) out of his estate each year. However, by making the $600,000 gift, he has also *removed* from his estate all the appreciation (if any) on the $600,000. If the $600,000 gift appreciates at an average annual rate of 2.0834%, the person who can make such a gift can better avoid estate tax under the cumulative use model by making the large gift and suffering the reduction in the annual exclusion.[228]

The taxpayer who can make the $600,000 gift will be able to avoid even more estate tax under the per donee model than under the cumulative use model, assuming that the taxpayer has five donees and a life expectancy in excess of two years after making the first set of five gifts under the annual exclusion. This is because under the per donee model, the annual exclusion is always $5,000. Thus, the taxpayer can only make a first round of annual exclusion gifts totalling $25,000, instead of the $50,000 that could be made under the cumulative use model. However, after the $600,000 gift, the taxpayer can continue to make $5,000 gifts under the per donee model, rather than $2,500 gifts as under the cumulative use model. With five donees, the $25,000 difference in the first round of gifts can be made up in two years of $5,000 gifts instead of $2,500 gifts.[229]

If, however, one assumes a taxpayer with no more than three donees, the greatest amount of estate tax could generally be avoided under the per donor model (if the $10,000 per donee and $20,000 per donor limitations are used). This will be true without regard to whether the taxpayer can make a

228. If the $600,000 gift appreciates at 2.0834% annually, the gift property will grow by $12,500 in the first year after the gift is made, and thereafter will grow by an amount larger than $12,500 per year (because of the compounding effect). Since the *growth* in the gift property escapes estate and gift tax in the hands of the donor, the growth in the $600,000 gift more than replaces the reduction in the annual exclusion if the average growth is 2.0834% or more.

229. This two year "make-up" will always occur so long as the taxpayer is assumed to have the same number of donees under each of the two models discussed.

$600,000 gift, as long as the donor can make the maximum annual exclusion gifts possible for more than three years. That is because with three or fewer donees, the effective per donee limitation under the per donor model is $6,666.66 or more, which is greater than the $5,000 limit under the cumulative use model after $30,000 worth of gifts are made. It is also greater than the $5,000 limit allowed under the universal reduction model.[230]

If the taxpayer had four donees, could afford to make a $600,000 gift, and has a more than a two year life expectancy after the first gifts are made, the taxpayer could avoid more estate tax under the per donor limitation than under the cumulative use model. That is because under the cumulative use model, after the $600,000 gift is made, the exclusion will be reduced to $2,500 per donee, while the effective per donee limit under the per donor model will be $5,000 where four donees are assumed. In fact, such a taxpayer could avoid more estate tax under the per donor model than the cumulative use model so long as the number of donees is less than eight, and his life expectancy is more than fourteen years after the first gifts are made.

Absent empirical data on how many taxpayers can and do utilize the annual exclusion, how many taxpayers can and do give away $600,000 (or some substantial portion thereof), the average number of donees the average donor has, and the life expectancy that donors have at the time they make such gifts, which model will actually be most effective at curtailing the use of the annual exclusion to avoid transfer taxes is not determinable with any real certainty. Since not all of this information is readily available to the government under the existing reporting system, the choice could not be made on an empirical basis until a substantial amount of information could be collected and analyzed.

Accordingly, until such information becomes available, the choice can only be made based on judgment and experience. Based on the analysis set forth above, a combination of the per donee and the per donor models would be effective and reasonably simple to implement.[231] Compared to present

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230. If the donor has three donees, under the cumulative use model he could make one $10,000 gift to each donee in one year, but in each year thereafter he could give only $5,000 per donee tax free under that model. Thus, he could give $30,000 in year one, and $15,000 in each succeeding year. By the end of the third year, he would have transferred $60,000. Under the per donor model, he could give $20,000 each year. By the end of the third year under that model, he could again have transferred $60,000. In the fourth year and each year thereafter, he could give away only $15,000 under the cumulative use model, but $20,000 under the per donor model.

231. The Restructuring Report, supra note 171, at 401, suggested that a per donor limitation be adopted as a means of preventing large scale wealth transfers under the exclusion by those with many donees, but did not recommend any reduction in the per donee limitation. Unless $10,000 per donee turns out to be the average amount of annual exclusion-type gifts made by persons who have $600,000 or less of property, which seems unlikely, failing to

law, this combination (assuming the $5,000 exclusion amount) would halve the amount any taxpayer with four or fewer donees could transfer under the annual exclusion, and would cut the amount in less than half for taxpayers with more than four donees.

Certainly, the per donor and cumulative use models could also be combined. This offers the possible further reduction in the annual exclusion to $2,500, which, if reducing tax-free wealth transfers were the only goal, might be compelling. However, under the cumulative use model, some taxpayers will incur an obligation to file a return with respect to gifts to one donee in excess of $2,500, while no taxpayers will incur this obligation under the per donee model. Thus, the combination of the per donor and cumulative use models has the potential for requiring more returns to be filed.

But an even more important element in choosing the per donee/per donor joint model as opposed to a cumulative use/per donor model is the "explainability" of the law. The $20,000 per donor cap is not particularly complex to explain in its own right. Thus, assuming that it would be adopted with either of the other models, it would not be a factor in choosing between the other two. However, the mere ease of stating and applying the per donee model, compared to the complexity of stating and applying the cumulative use model, is a significant factor favoring the per donee model.

2. *Choosing Among the Less Direct Modifications.*—Changing the present interest requirement, reducing the annual exclusion amount available to married persons, and adopting new reporting requirements would less directly affect the annual exclusion than would the modifications discussed above. Nonetheless, each of these possible changes would affect the use of the exclusion and determining which, if any, of them should be adopted is worthwhile.

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reduce the per donee limitation is unacceptable.

Gutman, on the other hand, argues that if the per donee limit is reduced to an appropriate amount, there is no need to adopt a per donor cap also. Gutman Comment, supra note 170, at 659. The logic of Gutman's position is irrefutable. However, it seems likely that on an issue like this, which has the potential to affect a substantial number of taxpayers and to cause the government a substantial administrative burden, lawmakers will choose to pick an amount at the high end of any range of figures presented to them. Thus, it seems desirable to have an overall cap which will reduce large scale wealth reduction through use of the exclusion.

Steinkamp, supra note 171 at 170-71, argues that using only a per donee exclusion is consistent with the purpose of the exclusion to protect ordinary gifts, which are made to individual donees, and that if the exclusion is too large then the per donee limit should be reduced. However, if the per donee limit is set large enough to cover recurring gifts (such as birthdays and holidays), and also to cover special occasion gifts (such as weddings and graduations), a per donor limitation should seldom prove to be too restrictive.

Retaining a per donee limitation, as recommended above, requires that there be a present interest requirement or some substitute for it in order to make it possible to value the amount transferred to each donee. While a per donee limit is desirable to retain, the use of meaningless withdrawal rights to create a present interest should be eliminated. Gutman would eliminate the use of withdrawal rights to create a present interest by denying the annual exclusion for transfers into trust, an approach that would also limit or make more difficult the transfer of certain types of assets under the annual exclusion.[232] The type of assets transferred is an appropriate thing to limit in consumption type transfers, but it is not an appropriate thing to limit for the types of gifts that the annual exclusion was meant to protect. The suggestion of the ABA Task Force to require an annual exclusion gift in trust to be usable for only one beneficiary, and, to the extent not so used, to be includible in that beneficiary's gross estate, will permit a per donee limit to be retained and eliminate the use of withdrawal rights given solely to make a transfer a present interest. This approach also preserves for donors the use of trusts as vehicles to hold annual exclusion gifts. Accordingly, using a "vesting" approach to replace the present interest requirement is the most desirable alternative.

Reducing the annual exclusion available to a married person by fifty percent presents a difficult choice. Doing so would be based on the premise that a married couple should be treated as one person for transfer tax purposes. There are other transfer tax provisions that do this. Perhaps the most significant one is the unlimited marital deduction, which treats the married couple as a unit and allows deferral of all gift and estate tax liability

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232. Gutman, supra note 170, at 1245-46; Gutman Comment, supra note 170, at 658-59.

Steinkamp, supra note 171 at 174-78, argues that transfers in trust should qualify only if the trust benefits a single beneficiary and the beneficiary (or a guardian therefor) can withdraw the property at any time. His argument is that the exclusion is meant to cover incidental gifts and that most such gifts are made in a way that gives the donee control over the gift property, and thus gifts in trust should qualify only if they provide the donee essentially the same control.

Steinkamp's approach and that recommended herein are perhaps more alike than they are different, since each replaces the existing present interest requirement with an approach that assures the beneficiary some degree of benefit and control. To the extent they are different, Steinkamp would presumably argue that the nonlapsing withdrawal right included in his proposal would give the donee more control than the "vesting" approach recommended by this article, and that the nonlapsing withdrawal right will reduce the use of the exclusion to make large transfers of wealth. However, as discussed supra note 211, nonlapsing withdrawal rights can be, and probably often are, illusory. It also seems unnecessary to assume that incidental gifts must be gifts over which the donee obtains immediate control. So long as the beneficiary must *ultimately* receive the benefit of the gift and can control the ultimate disposition of it, there seems to be little room for abuse of the system.

on property given or left by one spouse to the other. Spouses are also treated as one person for certain purposes under Chapter 14 of the Code (dealing with valuation of transfers) and for purposes of section 6166 (dealing with the payment of estate tax in installments.[233] Hence, the treatment of spouses as one person for purposes of the annual exclusion could be said to be consistent with the treatment of spouses for some other transfer tax purposes.[234]

However, for purposes of other significant transfer tax provisions, such as the unified credit and the $1 million exemption from GSTT, spouses are treated as separate persons. Each spouse has a unified credit and each has his or her own GSTT exemption.[235]

One could argue that Congress has been inconsistent in the way it has treated married couples for transfer tax purposes. But this may not be an instance of Congressional inconsistency. Rather, the purposes served and the effects caused by the provisions treating spouses as one person may be sufficiently different from those served and caused by the other provisions to justify the different treatment. For example, the marital deduction provision is designed to make it easier for the surviving spouse to be supported and it affects primarily the timing of transfer taxation. The Chapter 14 provisions that treat spouses as one person also primarily affect the timing of transfer taxation, and section 6166 simply permits estate tax to be paid in installments.

On the other hand, the unified credit and the GSTT exemption are expressly designed to permit the transfer of certain amounts of wealth by an individual without tax. If married couples were treated as one person for purposes of these latter two provisions, so that each person had a credit and exemption one-half the size of that permitted single persons, the law would no doubt significantly and unjustifiably affect the decisions of some persons with respect to marriage. The annual exclusion, like the unified credit and the GSTT exemption, actually affects the amount of transfer tax paid. This suggests that, as with those other provisions, the spouses should be treated as separate persons in connection with the exclusion.

The purpose of the exclusion is, of course, to permit regular birthday, wedding, holiday, graduation and other type family gifts to be made without any reporting and without any cumulative transfer tax consequences. In a bygone era, where the great majority of married couples stayed together, and

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233. IRC §§ 2701(a)(1)(B), (e)(2)(A), (d)(3)(B); 6166(b)(2)(B), (D).

234. There are numerous instances in which spouses are treated as one person for income tax purposes. E.g., §§ 267(a)(1), (b)(1), (c)(4); 318(a)(1); 1361(c)(1). However, because the purposes and policies of the income and transfer tax systems are so different, the treatment of spouses as one person for income tax purposes is not persuasive as to the proper treatment of spouses for purposes of the annual exclusion.

235. IRC §§ 2010, 2631.

the children and grandchildren of one spouse were usually the descendants of the other spouse also,[236] and more generally one spouse may have held most of the property and the other spouse very little, limiting the annual exclusion available to a married couple to the same as that available to a single person might have been feasible. Today, there are many second and third marriages, an individual often has children and grandchildren from a prior marriage who are unrelated to the individual's current spouse, and often both spouses in a marriage have substantial amounts of property. Hence, spouses today may often have donees who are very important to them that they do not share, and each may feel strongly about giving the full amount of the annual exclusion to the donees he or she wishes to benefit. If, in fact, the annual exclusion amount is reduced to a level that is consistent with the purposes Congress stated in adopting the annual exclusion, it would be very difficult to justify cutting a married person's annual exclusion amount in half.

Finally, the gift tax and income tax return should be altered to make clear and effective explanations of the annual exclusion. Everyone should understand that birthday, holiday, wedding and other such gifts really do consume the annual exclusion. The forms and directions should also explain the expanded tuition and medical care exclusions.

3. *What These Changes Will Accomplish.*—It is true that the approaches selected will not *eliminate* the problems caused by the present annual exclusion.[237] However, if the present interest requirement is replaced as recommended, the gift and income tax returns are revised as suggested, and the per donor and per donee models are jointly adopted, many of the problems will be greatly reduced and the wealth transfer opportunity that the annual exclusion now represents will be seriously limited. The amount of wealth transferable under the annual exclusion by taxpayers with many or few donees would be greatly reduced. The vertical inequity and horizontal inequity caused or contributed to by the annual exclusion will also be reduced.[238]

VI. CONCLUSION

The annual exclusion presently serves several functions it was not intended to serve and should not serve. It has been presented by Congress as a kind of administrative simplification, intended to permit the types of

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236. It is assumed that most annual exclusion gifts are made to children and grandchildren of the donors.

237. See supra Part IV.

238. See the examples of vertical and horizontal inequities discussed supra Part IV B, C.

recurring gifts that occur among families and friends to be made without generating gift tax consequences. Yet, at its present level it permits major wealth transfers to be made tax-free, both directly (through gifts) and indirectly (through protecting life insurance premium payments from tax, and by seeming to be a category separate from recurring family and friend type gifts). In serving that function it causes some vertical inequity (those who are more wealthy can lower the effective transfer tax rates on the transfer of their wealth through regular use of the exclusion), and contributes to horizontal inequity (by making it less costly for those who can do insurance planning to avoid transfer taxes). Rather than being a simple exception to gift tax that permits small, regularly recurring gifts to be made, it is an effective and substantial exception to all of the federal transfer taxes, and, as currently constituted, is inconsistent with the general purposes of the transfer tax system.

Further, it presently serves, albeit inadequately, the function of protecting gifts made for support related purposes to persons to whom the transferor no longer has an obligation of support, such as nontuition transfers to students and nonmedical care transfers to the elderly and incompetent. In some instances it is entirely inadequate to protect the transfers from gift tax consequences, given the cost of education and of nonmedical care for the elderly and incompetent.

Accordingly, the exclusion should be revised so that it serves primarily the function for which it was adopted. The revisions that should best accomplish that goal are: (i) to reduce the exclusion to a substantially lower amount, such as $5,000, per donee, per year; (ii) to place a cap on each donor's annual exclusion gifts in any calendar year, such as $20,000; (iii) to revise the gift and income tax returns to make it clear to taxpayers that holiday gifts, birthday gifts and other types of recurring gifts are charged against the annual exclusion limit; (iv) to replace the present interest requirement so that the gifts must either be outright or for the benefit of a single donee in whose gross estate any unexpended amount will be included; and (v) to liberalize the tuition and medical care exclusions from gift tax so as to permit transfers for support of students, elderly and incompetent persons to be made free of gift tax without having to rely on the annual exclusion to protect those transfers from gift tax.

The appendix following sets forth statutory language designed to accomplish these revisions.

APPENDIX: THE STATUTE AS REVISED

The relevant portions of the revised section 2503 would read as follows:

(b) EXCLUSIONS FROM GIFTS.—

(1) IN GENERAL. Subject to the limitations set forth in paragraphs (2) and (3) of this subsection (b), the first $5,000 of gifts made by a donor to any person during the calendar year shall not be included in the total amount of gifts made by the donor during such year.

(2) $20,000 Annual Cap. The total amount excluded under paragraph (1) of this subsection in one calendar year shall not exceed $20,000.

(3) Other Requirements. A transfer to or for the benefit of an individual will not be excluded from the donor's total amount of gifts for the year under this subsection unless it is—

(A) outright, or

(B) if not outright, during the life of such individual no portion of the corpus nor of the income therefrom may be distributed to or for the benefit of any person other than such individual, and at the death of such individual the corpus and income not so distributed will be includible in his gross estate.

(e) EXCLUSION FOR CERTAIN TRANSFERS FOR TUITION, MEDICAL CARE, STUDENT EXPENSES AND CARE OF ELDERLY AND INCOMPETENT PERSONS.—

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

(2) QUALIFIED TRANSFER.—For purposes of this subsection, the term "qualified transfer" means the following.

(A) Any amount paid on behalf of an individual as tuition to an educational organization described in section 170(b)(1)(A)(ii) for the education or training of such individual.

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

(C) In a calendar year, the lesser of [a specified dollar amount] (adjusted for the cost-of-living index) or the total amount actually transferred outright to or expended for the benefit of, a student, where such amount is used within

the school year in which it is transferred for the housing, transportation, feeding, clothing, or providing of necessary books, supplies and fees of the student which are not paid from any other source. At the time of the transfer, the student must be registered at and attending an educational organization as defined in section 170(b)(1)(A)(ii) for not less than one-half the number of credit hours considered a full time load at such organization and must be in good standing at such organization. The number of years within which a qualified transfer may be made under this subparagraph (C) to any one student by a donor shall not exceed twice the number of years that a full-time student would require to obtain the degree that the donee student is seeking at the time the transfer is made. Only transfers in the form of cash or in the kind of property to be used by the student for housing, transportation, to eat, clothing or books for classes shall be permitted as qualified transfers under this subparagraph.

(D) In a calendar year, the lesser of $________ (adjusted for the cost-of-living index) or the total amount actually given outright to, or expended for the benefit of, the donor's parent, grandparent, aunt, uncle, great-aunt or great-uncle or any incompetent person (as defined by the Secretary in regulations), where such amounts are used currently for the housing, transportation, feeding, clothing or caretaking expenses of the donee not paid from any other source. Only transfers in the form of cash or in the kind of property to be used by the donee for housing, transportation, clothing or to eat shall be permitted as qualified transfers under this subparagraph.

(E) For purposes of subparagraphs (C) and (D) of this paragraph (2), no transfer of ownership of any real property or of any other tangible asset with a value greater than [a specified dollar amount] (adjusted for the cost-of-living index) shall be a qualified transfer.