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Reforming The Gift Tax And Making It Enforceable

Mitchell M. Gans

Maurice A. Deane School of Law at Hofstra University

Jay A. Soled

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ARTICLES

REFORMING THE GIFT TAX AND MAKING IT ENFORCEABLE

MITCHELL M. GANS AND JAY A. SOLED *

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Historically, the gift tax has performed the admirable role of safeguarding the integrities of both the estate and income taxes. Due to taxpayers' abilities to narrow the gift tax base and ignore their filing obligations, however, fulfillment of its historical roles is now in jeopardy. This analysis details how taxpayers circumvent their gift tax obligations and then sets forth reforms that Congress can readily institute to curb taxpayers' transgressions. Institution of these recommendations would enable the gift tax to continue fulfilling its historic functions.

* Mitchell M. Gans is the Steven A. Horowitz Distinguished Professor in Taxation at Hofstra University School of Law, and Jay A. Soled is a tax professor at Rutgers University.

INTRODUCTION

The United States gift tax is truly a unique tax insofar as it generates virtually no revenue. For 2005, the last year for which there is available data, the gift tax raised approximately \$2 billion¹ – considerably less than 0.1 percent of the overall revenue collected by the federal government for the same year and in stark contrast to the \$1.1 trillion that the income tax alone raised for the same tax year.² This 2005 collection figure, moreover, is not an aberration. Historically, the gift tax has raised very little revenue, and projections indicate that this trend is likely to continue.³

On the one hand, since taxpayers each have a \$1 million lifetime gift exemption amount that allows them to transfer amounts up to this threshold without being subject to the payment of any gift tax,⁴ this lack of revenue generation is not wholly unexpected. On the other hand, because of flaws in the gift tax, substantial amounts of wealth are transferred without the payment of any transfer tax. The two most important flaws are the significant shortcomings in the way assets are valued and the absence of well-conceived reporting and penalty systems.

This Article argues that if the gift tax is to be fully functional and to fulfill its historic missions – namely, to safeguard the integrity of the estate and income taxes⁵ – Congress must institute reforms. The first would be to put in place more accurate methodologies for valuing gifts of closely held business interests and certain trust contributions. The second would be to introduce a series of reporting requirements and a penalty structure that would enable the IRS to detect and punish those taxpayers who transgress their gift tax filing responsibilities.

To demonstrate that the gift tax and the reporting practices associated with it are in dire need of reform, we have organized this Article in the following fashion: By way of background, Part I sets forth the historic role of the gift tax. Part II highlights the salient features of the gift tax, including its reporting requirements and the penalties that apply to those taxpayers who are noncompliant; in addition, Part II also details taxpayer valuation stratagems that are designed to narrow the gift tax base. Part III makes recommendations

¹ INTERNAL REVENUE SERVICE, DATA BOOK 2005, at 1 (2006).

² *Id.*

³ See, e.g., INTERNAL REVENUE SERVICE, FISCAL YEAR RETURN PROJECTIONS FOR THE UNITED STATES: 2006 - 2013, at 7 (2006).

⁴ I.R.C. § 2505 (2002). Congress introduced the lifetime gift exemption in 2001. Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, § 521(b), 115 Stat. 38, 71-72 (2001) (codified as amended in scattered sections of 26 U.S.C.). Prior to 2001, Congress had instituted what was known as the unified credit, which allowed taxpayers during their lifetimes and upon their deaths to transfer, in the aggregate, up to \$600,000 free from transfer tax. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, §§ 401-402, 95 Stat. 172, 299-301.

⁵ See generally *infra* notes 8-23 and accompanying text.

on how Congress can restore soundness to the gift tax and bolster overall taxpayer compliance. Finally, we present our conclusions.

I. HISTORIC ROLE OF THE GIFT TAX

Unlike other taxes, the gift tax does not serve an independent function.⁶ Rather, Congress designed it to protect the integrity of the estate tax and income tax.⁷ Strong historical support for this proposition is found in the congressional record.

Consider that in 1916 Congress introduced an estate tax.⁸ While arguments continue about the justification for the estate tax,⁹ no one has argued that the

⁶ Most taxes are designed to achieve particular goals, such as to raise revenue (e.g., the income tax), Terrence Chorvat & Elizabeth Chorvat, *Income Tax as Implicit Insurance Against Losses from Terrorism*, 36 IND. L. REV. 425, 427 (2003); regulate institutional behavior (e.g., the corporate tax), Reuven S. Avi-Yonah, *Corporations, Society, and the State: A Defense of the Corporate Tax*, 90 VA. L. REV. 1193, 1244 (2004); or curb undesirable conduct (e.g., so-called "sin taxes"), Samantha K. Graff, *State Taxation of Online Tobacco Sales: Circumventing the Archaic Bright Line Penned by Quill*, 58 FLA. L. REV. 375, 379 (2006) ("[Sin taxes] deter buyers from indulging in harmful products by making those products more expensive to obtain.").

⁷ Admittedly, another tax that shares this protective feature is the generation-skipping transfer (GST) tax. I.R.C. §§ 2601-2613 (2002). This tax applies in instances where transfers are made to so-called "skip persons" (in most instances, the donor's or decedent's grandchildren). I.R.C. § 2613 (defining a skip person as, inter alia, "a natural person assigned to a generation which is 2 or more generations below the generation assignment of the transferor"). The purpose of this tax is to protect the integrities of both the gift and estate taxes from wealthy taxpayers who could otherwise achieve long-term deferral of these taxes. The Tax Reform Act of 1976, Pub. L. No. 94-455, § 2006, 90 Stat. 1520, 1879-90 (containing a GST tax that Congress later repealed retroactively when it enacted another form of GST tax in 1986); see also Tax Reform Act of 1986, Pub. L. No. 99-51, §§ 1431-1433, 100 Stat. 2085, 2717-32. Several commentators have asked whether the introduction of the GST tax has proven counterproductive. See, e.g., Mary Louise Fellows, *Why the Generation-Skipping Transfer Tax Sparked Perpetual Trusts*, 27 CARDOZO L. REV. 2511, 2511 (2006) ("[T]he generation-skipping transfer (GST) tax exemption encouraged the creation of dynastic trusts and made those states that had no Rule Against Perpetuities . . . and no income tax on trusts particularly attractive as sites for settlors to establish [perpetual] trusts.").

⁸ See Revenue Act of 1916, ch. 463, §§ 200-212, 39 Stat. 756, 777-80 ("A tax . . . is hereby imposed upon the transfer of the net estate of every decedent dying after the passage of this Act.").

⁹ See, e.g., James R. Repetti, *Democracy, Taxes, and Wealth*, 76 N.Y.U. L. REV. 825, 825-26 (2001). For evidence that one role of the estate tax was to raise revenue, see H.R. REP. NO. 64-922, at 1 (1916) ("The necessity for [the estate tax] grows out of the extraordinary increase in the appropriations for the Army and Navy and the fortification of our country."); RANDOLPH E. PAUL, *TAXATION IN THE UNITED STATES* 104-09 (1954) (contemplating World War I as a significant incentive for congressional implementation of an estate tax); Louis Eisenstein, *The Rise and Decline of the Estate Tax*, 11 TAX L. REV.

estate tax can be effectively enforced without a gift tax: in the absence of a gift tax, the estate tax could be too easily defeated by lifetime gifts.¹⁰ To eliminate such strategies, in the Revenue Act of 1924, Congress instituted the gift tax as a companion to the estate tax.¹¹ After an initially rocky start (the gift tax was repealed two years after its introduction and then reinstated),¹² the gift tax has since been a "junior partner" to the estate tax.¹³

There was a second agenda associated with the passage of the gift tax, namely, preserving the integrity of the income tax's progressive rate structure.¹⁴ In 1916, Congress instituted a surtax to the income tax.¹⁵ This surtax, combined with the existing bracket structure of the income tax, made taxpayers' incomes subject to highly progressive tax rates.¹⁶ In this highly progressive rate environment, the gift tax proved necessary to avoid the practice of income shifting, whereby taxpayers could gift income-producing assets to related taxpayers whose income was taxed in lower income tax

223, 223-24 (1956) (tracing the historic progression of estate tax implementation and its purposes). For evidence that another role of the estate tax was to curtail wealth accumulations, see S. REP. NO. 73-558, at 7 (1934) (suggesting that increasing estate tax rates "will tend to prevent undue accumulation of wealth" and that this "objective is more properly reached by estate-tax than by income-tax increases"); K. Jay Holdsworth et al., *Report on Transfer Tax Restructuring*, 41 TAX LAW. 393, 396 (1988) ("The transfer taxes serve, among other purposes, to limit the perpetuation of large private concentrations of wealth . . .").

¹⁰ C. Lowell Harriss, *Legislative History of Federal Gift Taxation*, 18 TAXES 531, 533 (1940) ("[G]ifts . . . were costing much revenue, more . . . than tax exemptions . . .").

¹¹ Revenue Act of 1924, ch. 234, §§ 319-324, 43 Stat. 253, 313-16; see *Estate of Sanford v. Comm'r*, 308 U.S. 39, 44 (1939) ("An important, if not the main, purpose of the gift tax was to prevent or compensate for avoidance of death taxes.").

¹² Revenue Act of 1926, ch. 27, § 1200, 44 Stat. 9, 125 (repealing the gift tax); see also Gift Tax Act of 1932, ch. 209, §§ 501-532, 47 Stat. 169, 245-59 (reenacting the gift tax).

¹³ RICHARD B. STEPHENS ET AL., *FEDERAL ESTATE AND GIFT TAXATION* ¶ 1.03 [1] (7th ed. 1997); see also ROBERT H. MONTGOMERY & ROSWELL MAGILL, *FEDERAL TAXES ON ESTATES, TRUSTS AND GIFTS* 1935-36, at 275 (1935).

¹⁴ After the Republican chairman of the Committee on Ways and Means, Representative William R. Green of Iowa, made the point that the gift tax was needed as a necessary backstop to the estate tax, he added that the gift tax was also "needed on account of the income tax." 65 CONG. REC. 3119, 3120 (1924). Green explained that gifts of property could be used to avoid or reduce the tax on income from that property. *Id.*; see also 2 RANDOLPH PAUL, *FEDERAL ESTATE AND GIFT TAXATION* 359 (1942) (pointing out the perceived congressional need to institute a gift tax lest taxpayers "distribute income among a greater number of taxpayers . . . to reduce the surtax brackets").

¹⁵ Compare Revenue Act of 1926, ch. 463, § 1(b), 39 Stat. 756, 757 (imposing a top surtax rate of 13 percent), with War Revenue Act of 1917, ch. 63, § 2, 40 Stat. 300, 301 (imposing a top surtax rate of 50 percent).

¹⁶ See, e.g., Jeffrey L. Kwall, *The Uncertain Case Against the Double Taxation of Corporate Income*, 68 N.C. L. REV. 613, 619 n.32 (2000) (highlighting the normal rates and the surtax rates).

brackets.¹⁷ Institution of the gift tax thus was intended to make the practice of income shifting no longer economically viable from a tax-savings perspective.

In 1976, Congress unified the estate and gift taxes.¹⁸ Under unification, all lifetime gifts made after 1976 are, in effect, included in the calculation of the estate tax.¹⁹ To illustrate, suppose a taxpayer makes a \$1 million gift today, files a gift tax return reporting this gift, and then dies several years later with a gross estate of \$2 million. With respect to this illustration, the taxpayer's estate tax will be computed utilizing a tax base of \$3 million (the sum of the taxpayer's taxable estate of \$2 million plus the taxpayer's \$1 million prior taxable gift). The 1976 legislation essentially equated lifetime transfers to accelerated testamentary bequests and treated them, in most respects, as one and the same.²⁰

In 2001, Congress passed legislation that would, at least on a temporary basis, eliminate the estate tax.²¹ This same legislation, however, retained the gift tax.²² Legislative history reveals the reason for this retention: Congress had the same concern it harbored decades earlier that, absent a gift tax, taxpayers might easily defeat the progressive rate structure of the income tax by engaging, once again, in the practice of income shifting.²³ Retention of the

¹⁷ The Supreme Court has created an income tax doctrine that eliminates the opportunity for taxpayers to shift certain income to low-bracket relatives. *See, e.g., Lucas v. Earl*, 281 U.S. 111, 113-15 (1930). But the doctrine does not apply where an income-producing asset is gifted to a low-bracket taxpayer. In such a case, the recipient taxpayer is taxable on the post gift income. *Taft v. Bowers*, 278 US 470, 482 (1929). High-bracket taxpayers may also shift income to low-bracket taxpayers by gifting appreciated assets before they are sold, thereby causing the gain at the time of the sale to be taxed at the donee's bracket rate. For an excellent exposition of the assignment of income doctrine, see Charles S. Lyon & James S. Eustice, *Assignment of Income: Fruit and Tree as Irrigated by the P. G. Lake Case*, 17 TAX L. REV. 293, 296-300 (1961-62).

¹⁸ *See* Tax Reform Act of 1976, Pub. L. No. 94-455, §§ 200-210, 90 Stat. 1520, 1846-48 (unifying estate and gift taxes and adding a tax on generation-skipping transfers); Stanley S. Surrey, *Reflections on the Tax Reform Act of 1976*, 25 CLEV. ST. L. REV. 303, 319-28 (1976) (detailing the history and nature of the legislative changes that overhauled the transfer tax system).

¹⁹ *See* I.R.C. § 2001(b) (2002) (imposing a tax on the amount of the adjusted taxable gifts).

²⁰ One critical difference between the gift and estate taxes is that the gift tax is computed on a tax-exclusive basis whereas the estate tax is computed on a tax-inclusive basis. Also, gift tax values are determined on the date of the gift; in contrast, estate tax values are determined on the date of death.

²¹ Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, § 501, 115 Stat. 38, 69.

²² *Id.* § 511(d).

²³ *See, e.g., Jonathan G. Blattmachr & Mitchell M. Gans, Wealth Transfer Tax Repeal: Some Thoughts on Policy and Planning*, 90 TAX NOTES 393, 395 (2001) ("[T]hose who seek repeal . . . have not considered the ways in which taxpayers will be able to 'game' the

gift tax was thus seen as a necessary defense against the potential onslaught of aggressive taxpayers who, in order to mitigate or defeat their income tax burdens, would turn to income shifting.

These historic underpinnings have played a pivotal role in shaping the salient features of the gift tax. The question now is whether the gift tax, in terms of its application and its administration, can fulfill its historic missions of safeguarding the integrities of the estate and income taxes. In resolving this question, Part II of this analysis casts doubt.

II. ANALYSIS OF THE GIFT TAX

Congress generally imposes a gift tax on all gratuitous transfers of property, tangible or intangible, wherever located.²⁴ This definition theoretically furnishes the gift tax with a broad base upon which to impose a tax. Section A outlines the reasons why the gift tax base is not nearly as broad as one might anticipate, section B discusses the flaws in the reporting and penalty systems associated with gift giving, and section C offers a detailed illustration that portrays the systemic shortcomings of the gift tax.

A. *The Gift Tax Base*

Notwithstanding the fact that the gift tax appears to apply to any gratuitous transfer of property,²⁵ for reasons relating to public policy (e.g., promotion of education and health) and for administrative convenience, several kinds of gifts are not included in the gift tax base. Such nontaxable gifts include tuition payments,²⁶ medical remittances,²⁷ and so-called annual exclusion gifts (i.e.,

income tax system, and thereby undermine its progressive character, if repeal of the gift tax is achieved.”); John Buckley, *Transfer Tax Repeal Proposals: Implications for the Income Tax*, 90 TAX NOTES 539, 540 (2001) (suggesting that the gift tax eliminates transfers of property to aged relatives, a transaction that will become very attractive upon repeal of the gift tax); *Attorney’s Testimony at W&M Hearing on Bush Tax Relief*, TAX NOTES TODAY, Mar. 21, 2001, LEXIS, 2001 TNT 56-83 (summarizing Lauren Y. Detzel’s congressional testimony that “[i]f the gift tax is repealed, . . . taxpayers [will] give income producing assets to others in lower income tax brackets at no gift tax cost”). *But see* Ronald D. Aucutt, *Gift Tax Repeal Bill Minimizes Income Tax Problems*, 91 TAX NOTES 1015, 1016 (2001) (arguing against the need for retaining the gift tax in light of current laws that remove many opportunities for income tax abuse); Charles D. Fox IV & Svetlana V. Bekman, *Gift Tax Repeal: Responding to Opponents’ Concerns*, 92 TAX NOTES 1733, 1736 (2001) (“[G]ift tax supporters underestimate the ability of . . . laws to anticipate and prevent abuses.”).

²⁴ I.R.C. § 2511 (2002). The gift tax is imposed on the value of what the donor transfers, not what the donee receives. *Shepherd v. Comm’r*, 115 T.C. 376, 385 (2000) (citing, *inter alia*, *Robinette v. Helvering*, 318 U.S. 184, 186 (1943)), *aff’d*, 283 F.3d 1258 (11th Cir. 2002).

²⁵ I.R.C. § 2511.

²⁶ I.R.C. § 2503(e) (2002).

²⁷ *Id.*

those gifts such as wedding and birthday presents that do not annually exceed \$12,000 and that Congress deems too small in nature to take into account).²⁸ After tallying all the forms of gratuitous transfers that are excluded or exempt from gift tax, what remains? At least initially there would appear to be a fairly broad base of gratuitously transferred assets upon which the gift tax could be imposed.

But the gift tax base is far narrower than one might anticipate. In valuing assets, the Internal Revenue Code (Code) presently applies the so-called "willing buyer / willing seller" test.²⁹ This ostensibly evenhanded test declares that an asset's fair market value is equal to "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 sell, and both having reasonable knowledge of relevant facts."³⁰ Subsection (1) explores why, in the context of certain gratuitous transfers, application of the willing buyer / willing seller test artificially depresses asset values, unintentionally narrowing the gift tax base. Furthermore, subsection (2) inspects how another flawed valuation process applicable to trust contributions results in a similar narrowing of the gift tax base.

1. Application of the Willing Buyer / Willing Seller Test

By way of background, for gift tax purposes, the fair market value of an asset governs the amount of gift tax a transfer generates.³¹ Treasury regulations require use of the willing buyer / willing seller test to determine an asset's fair market value.³² For many items, such as bonds and marketable securities, application of the willing buyer / seller test results in the "correct" fair market value determination (i.e., were the donee to immediately turn around and sell the property in question, the sale proceeds would equal the result determined under the willing buyer / willing seller test).

But when it comes to valuing closely held business interests (whether in partnership or corporate form), the willing buyer / willing seller test proves deficient:³³ taxpayers are able to transfer items at artificially depressed

²⁸ I.R.C. § 2503(b) (excluding from the gift tax annual gifts of \$10,000 indexed by the CPI to 1998 dollars).

²⁹ See *United States v. Cartwright*, 411 U.S. 546, 551 (1973).

³⁰ Treas. Reg. § 25.2512-1 (as amended in 1992); see also Rev. Rul. 59-60, 1951-1 C.B. 237 (setting forth numerous criteria considered in determining fair market value).

³¹ I.R.C. § 2512(a) (2002).

³² See *supra* note 30.

³³ When it comes to the transfer of fractional interests in real property, application of the willing buyer / willing seller test also proves deficient, creating an environment where artificially depressed asset values are also prevalent. Courts routinely grant valuation discounts to fractional property interests; these discounts have a broad range. See *Propstra v. United States*, 680 F.2d 1248, 1249 (9th Cir. 1982) (applying a 15 percent discount); *Williams v. Comm'r*, 75 T.C.M. (CCH) 1758, 1764 (1998) (applying a 44 percent discount);

values.³⁴ More specifically, as applied in this context, the test permits taxpayers to capitalize upon so-called lack-of-control and marketability discounts. The lack-of-control discount is operative if the gifted interest represents a minority stake in the business venture (offering no governing voice);³⁵ the marketability discount is operative if the transferred interest is not freely tradable on a public exchange (such as the New York Stock Exchange or the NASDAQ).³⁶ Common combined minority and marketability valuation discounts often range from 15 percent to as high as 70 percent.³⁷

To illustrate how valuation discounts systematically depress the value of closely held business interests, consider the following example. Suppose Company *X* is worth \$1 million and *F* owns all ten of its outstanding shares. Suppose further that *F* transfers one of his Company *X* shares to his daughter, *D*. For gift tax purposes, rather than valuing this one share of stock representing a 10 percent interest at \$100,000, the one share of Company *X* stock would be valued at, say, \$60,000 to reflect the facts that a hypothetical purchaser of the gifted interest would not have control of the entity and such share would not be as readily marketable as a publicly traded share. Barring extenuating circumstances (i.e., explicit or implicit retention of control over such transferred interests, which could cause the discount to be disallowed through the application of the estate tax),³⁸ the courts have sanctioned the use

Stewart v. Comm'r, 31 B.T.A. 201, 206 (1934) (applying a 15 percent discount). The rationale courts offer for discounts of this nature is that a divided property interest is worth less than an undivided property interest because taxpayers lack complete control of the property's management. Shepherd v. Comm'r, 115 T.C. 376, 402 (2000), *aff'd*, 283 F.3d 1258, 1260 (11th Cir. 2002). Some courts, however, limit the size of the discount to the amount of anticipated expenses associated with instituting a partition action to separate the real property interests. See Kennedy v. Comm'r, 804 F.2d 1332, 1336 (7th Cir. 1986); Fittl v. Comm'r, 52 T.C.M. (CCH) 567, 571-72 (1986).

³⁴ See Karen C. Burke & Grayson M.P. McCouch, *Family Limited Partnerships, Discounts, Options, and Disappearing Value*, 6 FLA. TAX L. REV. 649, 655-65 (2004); Ronald H. Jensen, *The Magic of Disappearing Wealth Revisited: Using Family Limited Partnerships to Reduce Estate and Gift Tax*, 1 PITTSBURGH TAX REV. 155, 183-85 (2004); D. John Thornton & Gregory A. Byron, *Valuation of Family Limited Partnership Interests*, 32 IDAHO L. REV. 345, 349-60 (1996).

³⁵ See, e.g., Alan L. Feld, *The Implications of Minority Interest and Stock Restrictions in Valuing Closely-Held Shares*, 122 U. PA. L. REV. 934, 935-36 (1974) ("A minority interest in a corporation controlled by others may be worth significantly less than the liquidation value of the shares.").

³⁶ See, e.g., SHANNON P. PRATT ET AL., *VALUING A BUSINESS: THE ANALYSIS AND APPRAISAL OF CLOSELY HELD COMPANIES* 391-423 (4th ed. 2000).

³⁷ For an exhaustive and excellent summary of the discounts courts have permitted taxpayers, see Louis A. Mezzullo, *Valuation of Corporate Stock*, 831-3d TAX MGMT. PORTFOLIO wkst.1 (2007).

³⁸ See Mithcell M. Gans & Jonathan G. Blattmachr, *Strangi: A Critical Analysis and Planning Suggestions*, 100 TAX NOTES 1152 (2003) (discussing the grounds on which

of such discounts in the family setting,³⁹ and the IRS has reluctantly accepted the outcome of these decisions.⁴⁰

As presently applied, however, the willing buyer / willing seller test lacks dimension. The test's entire focus is on the price that an unrelated, hypothetical purchaser would pay for the gifted interest. While this approach is effective in most situations, it fails to account for the reality that, in the case of a harmonious family, the concerns that ordinarily animate minority discounts are not present.⁴¹ Put differently, while an unrelated purchaser would reduce the amount of the purchase price to reflect, for example, a concern about self-dealing by the controlling shareholder, these same concerns are usually absent in the related-party context. To the contrary, it is anticipated that related family members will work together; otherwise, the intrarelated party exchange would not have happened at the outset.⁴²

discounts can be disallowed via the estate tax); Daniel H. Ruttenberg, *The Tax Court's Execution of the Family Entity: The Tax Court's Application of Internal Revenue Code Section 2036(a) to Family Entities*, 80 N.D. L. REV. 41, 67-68 (2004) (explaining that transferred interest is includable in a decedent's gross taxable estate where the decedent's children implicitly agreed that the decedent would retain control over transferred property); Courtney Lieb, Comment, *The IRS Wages War on the Family Limited Partnership: How to Establish a Family Limited Partnership That Will Withstand Attack*, 71 UMKC L. REV. 887, 897-98 (2003) (recounting the Tax Court's position that the creation of a family limited partnership does not constitute a gift where the taxpayer retains control of the beneficial interest); Andrea B. Short, Comment, "Adequate and Full" Uncertainty: Courts' Application of Section 2036(a)(1) of the Internal Revenue Code to Family Limited Partnerships, 84 N.C. L. REV. 694, 714 (2006) (providing examples where retention of control "proved to be the downfall" of the estate); see also *Strangi v. Comm'r*, 417 F.3d 468, 478 (5th Cir. 2005) (holding that a taxpayer's retained interest was implied when partnership distributions were used to meet the taxpayer's daily living expenses); *Thompson v. Comm'r*, 382 F.3d 367, 376 (3d Cir. 2004) (holding that a ninety-five-year-old taxpayer who transferred nearly all of his assets into a family limited partnership retained an implied interest as to all the transferred assets). But see, e.g., *Kimbell v. United States*, 371 F.3d 257, 269 (5th Cir. 2004) (rejecting, on somewhat similar facts to *Thompson*, the IRS's claim that a ninety-six-year-old taxpayer who had transferred the vast majority of her assets into a family limited partnership held a retained interest as to all the partnership assets).

³⁹ See *supra* note 37.

⁴⁰ See Rev. Rul. 93-12, 1993-1 C.B. 202 (conceding for the first time that "a minority discount will not be disallowed solely because a transferred interest, when aggregated with interests held by family members, would be a part of a controlling interest").

⁴¹ See, e.g., *Newhouse v. Comm'r*, 94 T.C. 193, 251-52 (1990) ("Control means that, because of the interest owned, the shareholder can unilaterally direct corporate action, select management, decide the amount of distribution, rearrange the corporation's capital structure, and decide whether to liquidate, merge, or sell assets.").

⁴² It is conceivable that if an entity is controlled by a family and there is tension between or among family members, a minority discount would be appropriate if such discord could be established by clear and convincing evidence. See Rev. Rul. 81-253, 1981-2 C.B. 187, *revoked* by Rev. Rul. 93-12, 1993-1 C.B. 202.

The willing buyer / willing seller test also produces two different kinds of incongruous outcomes. The first is between gifts of different sizes. Consider, for example, a father who owns 100 percent of stock in a company. If he were to gift all of his company stock to his daughter, no minority discount would be available.⁴³ If, however, he gifted the same stock to her in three equal installments, a minority discount would suddenly become available for each installment of the three-prong gift.⁴⁴ On its face, such disparate outcomes for two transactions that are essentially the same in nature raise serious equity concerns.

A second incongruity produced by the willing buyer / willing seller test arises between applications of the gift and estate taxes. Consider the fact pattern set forth in Revenue Ruling 93-12.⁴⁵ In the ruling, a taxpayer owned 100 percent of a company's stock, which he simultaneously transferred in equal shares to each of his five children. The IRS ruled that, for gift tax purposes, the taxpayer could discount the value of each 20 percent interest owing to its lack-of-control / minority status. Suppose instead that, immediately before the taxpayer completed the gift, he died and bequeathed a 20 percent interest in the company to each of his five children. In such a case, due to his 100 percent controlling interest (immediately prior to death) no valuation discounts would be available for estate tax purposes.⁴⁶ Given that one of the gift tax's major purposes is to prevent lifetime transfers from escaping the estate tax, this inequity in the valuation process is particularly problematic.⁴⁷

⁴³ Indeed, any time a controlling block of shares (i.e., greater than 50 percent) is transferred, application of a control premium may be appropriate. See Rev. Rul. 59-60, 1959-1 C.B. 237, 241-42 (suggesting that forced sales do not reflect the fair market value of a controlling interest in a corporation).

⁴⁴ See *supra* note 35 and accompanying text.

⁴⁵ Rev. Rul. 93-12, 1993-1 C.B. 202 ("P transferred all of P's shares by making simultaneous gifts of 20 percent of the shares to each of P's five children, A, B, C, D, and E.").

⁴⁶ See, e.g., *Ahmanson Found. v. United States*, 674 F.2d 761, 768 (9th Cir. 1981) (holding that property must be valued in the hands of the estate and according no weight to the number of the estate's beneficiaries); *Bright v. United States*, 619 F.2d 407, 411-12 (5th Cir. 1980) (refusing to apply a family attribution principle in a situation where a decedent wife owned a 55 percent community property interest in company stock with her husband, despite the fact that the wife bequeathed a 27.5 percent interest to her husband as trustee, giving him effective company control).

⁴⁷ To capitalize upon these disparate outcomes, virtually every dying person has a clear financial incentive to make deathbed transfers of interests that they hold in their closely held businesses. See *Frank v. Comm'r*, 69 T.C.M. (CCH) 2255 (1995) (permitting such deathbed planning). But see *Murphy v. Comm'r*, 60 T.C.M. (CCH) 645 (1990) (rejecting such planning). Even if taxpayers are not successful in making lifetime transfers, married taxpayers can effectuate the same transfer tax savings via their testamentary planning. For example, a taxpayer who owns a controlling interest in a business, say 60 percent, can

In light of taxpayers' remarkable success in capitalizing upon valuation discounts,⁴⁸ it is not surprising that practitioners tout their use. Indeed, to capitalize on discounts, practitioners typically advise clients to "wrap" their assets – even marketable securities – in entities, thereby erasing a significant portion of the underlying value of such assets.⁴⁹ Narrowing the gift tax base

bequeath 30 percent outright to his spouse and 30 percent in a testamentary QTIP trust for the surviving spouse's benefit; upon the surviving spouse's demise, despite the fact that both interests in the company are included in the surviving spouse's estate tax return, each 30 percent interest will be valued separately and accorded lack-of-control discounts. See *Bonner v. United States*, 84 F.3d 196, 198 (5th Cir. 1996) (classifying the government's argument that "the interest held by a QTIP trust and the interest held by [decedent] merged at the time of [decedent's] death" as "not supported by precedent or logic"); *Mellinger v. Comm'r*, 112 T.C. 26, 35 (1999) (declining to aggregate decedent's shares held in a QTIP trust and shares in another trust for valuation purposes even though the aggregate constituted a controlling interest in the company), *acq. in result*, 1999-35 I.R.B. 314, *as corrected by* Announcement 99-116, 1999-2 C.B. 763. But see *Fontana v. Comm'r*, 118 T.C. 318, 322 (2002) (expressing an unwillingness to extend the holding in *Mellinger* to cases in which the surviving spouse held a general power of appointment over the trust, which the Tax Court equated with outright ownership).

⁴⁸ Under current law, the establishment of closely held business interests will be respected for transfer tax purposes – resulting in discounts in valuing the gift of an interest in such an entity – even if the entity was formed solely for tax purposes. See *Knight v. Comm'r*, 115 T.C. 506, 513-14 (2000) (reasoning that a partnership that is valid under applicable state law will be treated as a partnership under federal tax law regardless of the motive for creating it). If the entity were disregarded for tax purposes where the taxpayer failed to demonstrate a business purpose, much abuse would be eliminated. For a discussion of a business-purpose requirement and how it might be adopted by regulation, see Mitchell M. Gans, *Deference and Family Limited Partnerships: A Case Study*, 39 INST. ON EST. PLAN. ¶ 500 (2005) [hereinafter *Deference*]. Note, however, that the absence of a non-tax purpose could be relevant to the estate tax treatment of these entities. See *Strangi v. Comm'r*, 417 F.3d 468, 479-80 (5th Cir. 2005) (indicating that a non-tax purpose must be established if the taxpayer is to qualify for the bona fide exception in I.R.C. section 2036).

⁴⁹ See generally Eric Thomas Carver, *Probate Law: A Valuation Primer; Trends and Techniques for Estate Planners*, 77 MICH. B.J. 1304 (1998); S. Stacy Eastland, *The Art of Making Uncle Sam Your Assignee Instead of Your Senior Partner: The Use of Partnerships in Estate Planning*, SK069 ALI-ABA 999 (2005) (outlining the advantages and disadvantages of creating and transferring partnership interests and providing techniques to facilitate their use); Timothy R. Baumann, Note, *Family Limited Partnerships, Trusts, or Limited Liability Corporations: Which Should the Elderly Choose?*, 3 ELDER L.J. 111 (1995) (discussing how the elderly may use family limited partnerships and limited liability corporations to protect assets from creditors and save taxes). In designing section 2704, Congress tried to limit taxpayers' use of entities for the primary purpose of defeating transfer taxes; however, this section has largely proven a failure. For a discussion of section 2704's deficiencies, see *Deference*, *supra* note 48, at 5-22 to -24. Regulations under section 2704(b)(4) are currently being considered to address some of these deficiencies. See Press Release, Office of Tax Policy, 2007-2008 Priority Guidance Plan (Aug. 13, 2007) available at [http://www.ustreas.gov/press/releases/reports/0708_gpl_\(2\).pdf](http://www.ustreas.gov/press/releases/reports/0708_gpl_(2).pdf).

has become an amateur sport of sorts in which all wealthy taxpayers are apparently welcome to participate.⁵⁰

2. Valuing Trust Contributions

Certain forms of trusts permit taxpayers to undervalue their gifts, further narrowing the gift tax base. These trusts typically come in two varieties: grantor-retained annuity trusts (GRATs) and qualified personal residence trusts (QPRTs). Taxpayers establish these trusts with a singular purpose in mind: to transfer wealth free of gift and estate taxes.⁵¹ Even though these trusts are established strictly with tax savings in mind, the Code explicitly authorizes them.

Congress itself inadvertently provided taxpayers with the trust “tools” that they now use to chisel away at the gift tax base. In an attempt to preclude taxpayers from running roughshod over the valuation process, Congress added chapter 14 to the Code.⁵² This relatively new Code chapter, entitled “Special Valuation Rules,” was intended to offer certainty and clarity to the transfer tax

⁵⁰ The courts have begun to scrutinize these entities more carefully. For example, where marketable securities are contributed, the courts have allowed a more limited minority discount. *See, e.g., Dallas v. Comm’r*, 92 T.C.M. (CCH) 313, 319 (2006) (applying a 15 percent minority discount to the value of a partnership’s nonoperating assets but a 20 percent discount to the operating assets’ value); *McCord v. Comm’r*, 120 T.C. 358, 383-86 (2003) (applying a 10 percent minority discount to the municipal bond component of a partnership interest but a 23 percent discount to the real estate component), *rev’d on other grounds*, 461 F.3d 614 (5th Cir. 2006); *Peracchio v. Comm’r*, 86 T.C.M. (CCH) 412, 417 (2003) (using a 2 percent minority discount factor for the “cash and money market funds” asset category of a family limited partnership and higher discount factors for other assets); *Lappo v. Comm’r*, 86 T.C.M. (CCH) 333, 339 (2003) (finding an 8.5 percent discount appropriate for the marketable securities component of a partnership interest and a 19 percent minority interest discount appropriate in the real estate component of the same partnership). In addition, in some cases, the courts have denied any discount on the basis of section 2036, *see supra* note 38, or on the ground that the assets transferred to the entity have been gifted, in substance, to other family members. *See, e.g., Senda v. Comm’r*, 433 F.3d 1044, 1046 (8th Cir. 2006) (affirming the Tax Court’s determination that “contribution of stock [to a partnership] after the transfer of partnership interests is an indirect gift to the partners”); *Shepherd v. Comm’r*, 283 F.3d 1258, 1260 (11th Cir. 2002) (holding that a taxpayer’s transfer of minority shares in leased property to his two sons through a family partnership “was an indirect gift of land, and not partnership interests”). For a more detailed discussion on this point, see generally Mitchell M. Gans & Jonathan G. Blattmachr, *Family Limited Partnership Formation: Dueling Dicta*, 35 CAP. L. REV. 1 (2006).

⁵¹ Taxpayers do not form these trusts for the traditional reasons, such as safeguarding designated beneficiaries from financial vicissitudes, *see* AUSTIN W. SCOTT & MARK L. ASCHER, *THE LAW OF TRUSTS* § 151 (4th ed. 2001) (discussing a spendthrift trust); eliminating ancillary jurisdiction, *see id.* § 330 (discussing revocable trusts); or benefiting an eleemosynary institution, *see id.* § 348 (providing the definition of a charitable trust).

⁵² Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, § 11602, 104 Stat. 1388-490 to 1388-501.

valuation process where there was previously a perceived void.⁵³ Yet, after the enactment of chapter 14, taxpayers could exploit certain forms of trust that the Code itself now specifically sanctions. And that is, of course, exactly what taxpayers did.

Two forms of trust found in chapter 14, both sanctioned under section 2702, are emblematic of how taxpayers turned a seeming defense against valuation abuse into a Maginot Line. Under section 2702, taxpayers may establish GRATs or QPRTs.⁵⁴ GRATs and QPRTs allow taxpayers to make gargantuan trust contributions that, when properly structured, the gift tax deems lilliputian.⁵⁵ For the moment, without delving into the complex technical

⁵³ By way of background, in the early 1980s taxpayers had devised many so-called estate tax “freezes,” i.e., techniques that allowed taxpayers to simultaneously transfer wealth, retain control, and minimize their transfer tax burdens. See Byrle M. Abbin, *The Value-Capping Cafeteria – Selecting the Appropriate Freeze Technique*, 15 U. MIAMI INST. EST. PLAN. ¶ 2000, ¶ 2014 (1981). One technique in particular, the establishment of grantor-retained income trusts (GRITs), allowed many taxpayers to achieve far superior results than had they made outright gifts. See generally Mitchell Gans, *GRIT's, GRAT's AND GRUT's: Planning and Policy*, 11 VA. TAX REV. 761 (1992) [hereinafter *GRIT's, GRAT's, GRUT's*] (discussing the advantages, tax implications and strategies of grantor-retained income trusts, grantor-retained annuity trusts, and grantor-retained unitrusts); Harry F. Lee, *The Economics of a GRIT*, 68 TAXES 555 (1990). To foreclose this transfer tax planning opportunity and many other perceived estate tax freeze abuses, in 1987, Congress responded by adding section 2036(c) to the Code. See Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203, § 10402(a), 101 Stat. 1330, 1330-431 to -432. This Code section was specifically targeted to preclude taxpayers from utilizing such valuation stratagems. See Joseph M. Dodge, *Rethinking Section 2036(c)*, 49 TAX NOTES 199, 201 (1990); Thomas Earl Geu, *Selected Estate Planning Aspects of the Uniform Limited Partnership Act* (2001), 37 SUFFOLK U. L. REV. 735, 768 (2004). Code section 2036(c), however, proved difficult to administer and hard to comprehend. See 136 CONG. REC. S15.680 (daily ed. Oct. 18, 1990) (describing, in an informal committee report printed in the Congressional Record, the section's “complexity, breadth, and vagueness,” which created “an unreasonable impediment to the transfer of family businesses,” and expressing further concern that “many taxpayers [had] refrained from legitimate intrafamily transactions because of uncertainty about the scope of its rules”). Several years later, after an avalanche of complaints, see STAFF OF JOINT COMM. ON TAXATION, 101ST CONG., PRESENT LAW AND PROPOSALS RELATING TO FEDERAL TRANSFER TAX CONSEQUENCES OF ESTATE FREEZES 24-25 (Comm. Print 1990), Congress repealed section 2036(c). Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, § 11601, 104 Stat. 490-91.

⁵⁴ See I.R.C. § 2702 (2002).

⁵⁵ In contrast to outright gifts, taxpayers who establish QPRTs and GRATs incur a risk that they may not survive the term of the trust; and if they do not, estate tax inclusion occurs under Code section 2036 (or in the case of a GRAT, under Code section 2039). See Rev. Rul. 82-105, 1982-1 C.B. 133 (equating retention of the right to receive income from an annuity with retention of the right to income from a portion of the property transferred); I.R.S. Priv. Ltr. Rul. 2002-10-009 (Nov. 19, 2001) (“Under § 2039, the entire value of the GRAT on the date of Decedent's death is includible in the Decedent's gross estate.”); I.R.S. Priv. Ltr. Rul. 93-45-035 (Aug. 13, 1993) (“[I]f A does not survive the term of the trust, the

aspects of each trust form,⁵⁶ consider a simple illustration of how each trust operates.

At a time when the applicable federal rate under section 7520 is 5 percent, a taxpayer contributes title to rapidly appreciating real estate worth \$1 million to a GRAT that has a two-year term, retaining the right to receive back from the trust a \$550,000 annual annuity. Because of the taxpayer's sizable retained interest (i.e., the right to receive two \$550,000 annuity payments), section 2702 and the regulations promulgated thereunder indicate that the value of the taxpayer's retained interest is \$1 million. That being the case, the value of the remainder interest deemed passing to the trust remainder beneficiaries is \$0 (\$1 million contribution less the taxpayer's \$1 million retained interest). If, over the two-year trust period, the contributed real estate appreciates by more than 5 percent, any monies or property remaining in the trust after the two-year termination period will pass tax-free to the trust's remainder beneficiaries.

In selecting assets to contribute to GRATs, taxpayers will actively select those assets they think will outperform the applicable section 7520 rates (these rates, promulgated monthly, fluctuate with the midterm federal interest rates and are designed to pinpoint the value of taxpayers' retained interests).⁵⁷ As will be shown, if a taxpayer's choice of trust contributions proves misguided, there is little downside risk to the taxpayer.⁵⁸

amount includible in A's gross estate under section 2039 of the Code will be the value of the trust corpus at that time."'). For a discussion of strategies that possibly eliminate the risk attendant to section 2036, see Jonathan G. Blattmachr & Andrew D. Painter, *Planning for Split-Interest Transfers Under the Section 2702 Final Regulation*, 77 J. TAX'N 18, 21 (2002) (suggesting that "a sale of a remainder in a personal residence should fall under the personal residence exception" and avoid inclusion of a QPRT if the taxpayer fails to survive the term of the trust).

⁵⁶ The more technical aspects of each trust are discussed *infra* at II.C.

⁵⁷ See Treas. Reg. § 20.7520-1(b) (as amended in 2000) (prescribing that the pertinent rate is 120 percent of the midterm applicable rate, using annual compounding, rounded to the nearest two-tenths of 1 percent).

⁵⁸ Put differently, for gift tax purposes, taxpayers take the position that they can have a retained interest in the contributed trust property that equals the fair market value of the contributed trust property, negating any taxable gift. See *Walton v. Comm'r*, 115 T.C. 589, 596-97 (2000) (unanimously striking down a regulation that did not treat payments made to a grantor's estate as a retained interest if the grantor died during the course of the trust term). By issuing new regulations, the IRS has subsequently acquiesced in the outcome of the *Walton* decision. These regulations permit taxpayers to treat unitrusts as retained interest annuity payments that continue to be paid to their estates if they die during the term of the trust. Treas. Reg. §§ 25.2702-2(a)(5), 25.2702-3(e) ex. 5 (as amended in 2005) (including the holder's estate within the definition of a "holder" of a unitrust and indicating that if a settlor retains the right to receive a percentage of the trust for a certain term of years, the unitrust amount is to be paid to the settlor's estate for the balance of the term in the event of the settlor's death). Nevertheless, in separate guidance issued prior to the promulgation of this regulation, the IRS remarked that GRAT arrangements in which "the value of the remainder interest (and thus, the amount of the gift) is zero or of nominal value

At a time when the applicable federal rate under section 7520 is 5 percent, a taxpayer contributes title to her home, worth \$1 million, to a QPRT that has a twenty-year term, retaining the right to the trust's income (which, in this case, constitutes a right to reside in the home free of paying any rent). Pursuant to section 2702, the value of the taxpayer's retained interest would equal \$900,000, and the value of the remainder interest passing to the trust remainder beneficiaries is accordingly \$100,000 (\$1 million value of the contributed house less the taxpayer's \$900,000 retained interest). Thus, at the termination of the QPRT, the remainder beneficiaries will receive the house with a likely value of \$1 million or more, even though the taxpayer is deemed to have made a taxable gift of only \$100,000. If the value of the house remains constant, the remainder beneficiaries would receive a house with a value of \$1 million at the QPRT's termination. If, as is more likely the case, the house appreciates during the QPRT's term, the remainder beneficiaries will enjoy that appreciation as well.

If, conversely, the value of the house should decline, the advantages that the QPRT offers are reduced. To illustrate, assume that at the QPRT's termination, the value of the house was \$0; in such a case, the taxpayer would have used up \$100,000 of his lifetime gift tax exemption without affecting any transfer of wealth. In this situation, a more favorable outcome could have been achieved had the taxpayer, in lieu of establishing the QPRT and funding it, made an outright asset transfer of equivalent value (i.e., \$100,000) that produced a positive economic return.

In determining whether to contribute their primary residences or vacation homes to a QPRT, taxpayers will select those properties that have the greatest chance to appreciate (rather than depreciate) in value.⁵⁹ Taxpayers who choose wisely in their trust contributions will be richly rewarded: they are able to gift

[are] contrary to the principles of § 2702." I.R.S. Tech. Adv. Mem. 2002-45-053 (Nov. 8, 2002). This remark signifies the unsettled nature of this area of the law and is illustrative of the fact that the IRS may still challenge practitioners' use of so-called zeroed-out GRATs.

⁵⁹ As always, the advantages of making a contribution to a QPRT must be weighed against making an outright gift of the same property. Consider, for example, if the same \$1 million home presented in the text was instead gifted outright to the people who were to be the remainder trust beneficiaries. Over the same twenty-year period, the beneficiaries could charge the taxpayer fair market value rent for residing in the property, the title to which they now own. The higher the fair market value rent they can charge, the more attractive the outright gift becomes relative to the contribution to the QPRT; conversely, the lower the fair market value rent they can charge, the less attractive the outright gift becomes relative to the contribution to the QPRT. Another comparative advantage of the outright gift is that the death of the donor will not cause any subsequent estate tax inclusion; in the case of the QPRT, however, should the donor die anytime during the retained trust term, the entire fair market value of the residence (including any appreciation therein) becomes taxable in the donor's gross estate. I.R.C. § 2036(a) (2002). For a further discussion of the advantages of a QPRT, see *GRIT's*, *GRAT's*, *GRUT's*, *supra* note 53, at 805-11.

enormous amounts of wealth to trust remainder beneficiaries at greatly discounted values.⁶⁰

B. Reporting and Penalty Systems

Notwithstanding the “voluntary” nature of our nation’s tax system, it works for a variety of reasons. One reason compliance is relatively high is that taxpayers believe that if they are noncompliant, the IRS will uncover their transgressions and impose civil as well as possible criminal sanctions.⁶¹ When it comes to the gift tax, however, many taxpayers do not harbor these same fears because (1) they know their chances of being caught are infinitesimally small and (2) even if they are caught, they are not likely to be penalized.

1. The IRS’s Inability to Detect Noncompliance

With respect to its ability to detect taxpayer noncompliance, the odds are deeply stacked against the IRS, particularly when it comes to gift tax transgressions. As a general proposition, the IRS is a beleaguered administrative agency. More specifically, the IRS is woefully underfunded, and, over the past several years, the scope of its responsibilities has greatly expanded.⁶² This anemic funding, coupled with the augmentation of the agency’s responsibilities, has severely hampered the IRS’s ability to monitor taxpayer compliance, as evidenced by the paltry number of annual income tax

⁶⁰ See Lawrence P. Katzenstein, *Running the Numbers: An Economic Analysis of GRATS and QPRTs*, SL078 ALI-ABA 779, 781 (2006) (“Grantor retained annuity trusts (‘GRATs’) and qualified personal residence trusts (‘QPRTs’) have become standard weapons in the estate planner’s arsenal.”).

⁶¹ See *JCT Reviews IRS Plans, Budget*, TAX NOTES TODAY, May 17, 2005, LEXIS, 2005 TNT 95-13 (“In a recently released survey, 51 percent of taxpayers identified fear of an audit as having either a great deal of influence or somewhat of an influence on whether they report and pay their taxes honestly.”). See generally Alex Raskolnikov, *Crime and Punishment in Taxation: Deceit, Deterrence, and the Self-Adjusting Penalty*, 106 COLUM. L. REV. 569 (2006) (analyzing potential penalties for tax avoidance from an economic approach to deterrence).

⁶² Indeed, Congress has charged the IRS with the responsibility of monitoring and administering many social welfare programs, including the earned income tax credit for low-income wage earners. See Dennis J. Ventry, Jr., *The Collision of Tax and Welfare Politics: The Political History of the Earned Income Tax Credit, 1969-99*, 53 NAT’L TAX J. 983, 1005 (2000) (relating the adoption of the earned income tax credit). More recently, the IRS has been called upon to administer disaster relief. See generally Meredith M. Stead, *Implementing Disaster Relief Through Tax Expenditures: An Assessment of the Katrina Emergency Tax Relief Measures*, 81 N.Y.U. L. REV. 2158 (2006) (discussing the Katrina Emergency Tax Relief Act of 2005 and providing arguments for and against the administration of emergency relief by the Internal Revenue Service).

audits that the IRS presently conducts.⁶³ Furthermore, just last year, the IRS decided to halve the number of staff personnel in its estate and gift tax audit branch,⁶⁴ metaphorically keeping its fingers crossed and hoping that taxpayers will be compliant. This strategy, however, does not appear to be working: compliance with the gift tax appears to be ebbing.⁶⁵

In the case of income taxes, a wide array of third-party information reporting requirements are in place to ensure compliance. If taxpayers earn wages, their employers must report such earnings on a Form W-2;⁶⁶ if taxpayers receive interest income on an investment, the payer must report such income on a Form 1099-INT;⁶⁷ if taxpayers sell securities, the broker must report the amounts realized from these sales on a Form 1099-B.⁶⁸ These examples are but a smattering of all the information returns the Code requires third parties to provide to bolster income tax compliance.⁶⁹ The issuance of such information returns is not for naught: empirical studies repeatedly indicate that the issuance of these third-party information returns plays a critical role in ensuring taxpayer compliance.⁷⁰

⁶³ See U.S. GOV'T ACCOUNTABILITY OFFICE, INTERNAL REVENUE SERVICE: ASSESSMENT OF THE FISCAL YEAR 2006 BUDGET REQUEST 11 (2005) (IRS audit rates declined steeply from 1995 to 1999, but the audit rate has slowly increased since 2000).

⁶⁴ See Allen Kenney, *IRS Plans Significant Cuts to Estate Tax Program*, TAX NOTES TODAY, July 24, 2006, LEXIS, 2006 TNT 141-1 (reporting the IRS's plans to drastically reduce the number of estate tax return auditors). The *New York Times* reports thus:

The federal government is moving to eliminate the jobs of nearly half of the lawyers at the Internal Revenue Service who audit tax returns of some of the wealthiest Americans, specifically those who are subject to gift and estate taxes when they transfer parts of their fortunes to their children and others.

David Cay Johnston, *I.R.S. Will Cut Tax Lawyers Who Audit the Richest*, N.Y. TIMES, July 23, 2006, at A16. The effect of this staff cut will be to further reduce the paltry number of gift tax audits the IRS presently conducts. See INTERNAL REVENUE SERVICE DATA BOOK 23 tbl.9 (2006) (indicating that the IRS audits less than 1 percent of all the gift tax returns that are filed).

⁶⁵ See JONATHAN FEINSTEIN & CHIH-CHIN HO, IRS, U.S. DEP'T OF TREASURY, THE IRS RESEARCH BULLETIN, PUB. 1500, at 47-53 (rev. Nov. 1999) (estimating that approximately one-half of all gift tax payments are evaded); David Joulfaian, *The Federal Gift Tax: History, Law, and Economics* 29-32 (Jan. 2007) (unpublished manuscript), available at <http://ssrn.com/abstract=940871>.

⁶⁶ Treas. Reg. § 1.6041-2(a) (as amended in 2004).

⁶⁷ Treas. Reg. § 1.6049-4 (as amended in 2006).

⁶⁸ Treas. Reg. § 1.6045-1 (as amended in 2006).

⁶⁹ See, e.g., I.R.C. §§ 6050A-6050V (2002) (providing a laundry list of instances in which information returns must be filed).

⁷⁰ See *IRS Republishes Fact Sheet on Third-Party Reporting*, TAX NOTES TODAY, Aug. 31, 2006, LEXIS, 2006 TNT 177-12 ("[E]xperience shows that taxpayers are much more likely to report their income when they receive third-party notification of payments they received."); U.S. GEN. ACCOUNTING OFFICE, TAX GAP: MANY ACTIONS TAKEN, BUT A COHESIVE COMPLIANCE STRATEGY NEEDED 5 (1994), available at <http://archive.irs.gov>.

In the case of estate taxes, third parties – namely, an estate's executors – are required to file an estate tax return (Form 706) with the IRS. In most instances, this reporting obligation creates a self-policing mechanism: an estate's executors will not ordinarily risk bearing civil penalties or possible criminal prosecution to save tax dollars that inure to others (i.e., the estate's beneficiaries). The only situation when this self-policing mechanism is not operative is when an estate's executors are also the estate's sole beneficiaries.⁷¹

When it comes to gift tax enforcement, however, the issuance of any third-party information returns is noticeably absent, and there is no self-policing mechanism in place. Consider that current reporting practices require taxpayers who make gifts to nonspousal beneficiaries in excess of the annual gift tax exclusion (currently, \$12,000) to file a gift tax return.⁷² Yet, there are no third-party reporting mechanisms in place to ensure that taxpayers will comply with their filing obligations. The burden of accurately reporting gifts falls entirely to the taxpayer, and, when it comes to self-reporting, it is empirically well-known and documented that taxpayers often fall short of the required compliance mark.⁷³

Aside from the absence of third-party information return issuance, there is another major distinction between income and gift taxes – the potential of an audit. Most taxpayers actively or passively earn income (e.g., wages, interest, and dividends) and, accordingly, must annually file an income tax return. The IRS therefore has reason to consider virtually every person an audit target; indeed, the very absence of a tax return submission (or a tax return submission that reflects an exceedingly low amount of income) might, in and of itself, trigger an income tax audit. Thus, random income tax audits play an important role in instilling taxpayer compliance and in generating revenue.

In the sphere of the gift tax, though, random audits cannot play this same important compliance role. There are several reasons for this. First, random gift tax audits would likely be perceived as highly intrusive (and thus politically unacceptable). Second, due to the lifetime gift tax exemption (currently, \$1 million), random audits would not likely generate any immediate revenue.⁷⁴ Third, many forms of gifts can be readily camouflaged (e.g., paying to have a child's house remodeled), making the random audit process extraordinarily unlikely to reveal taxpayers' derelictions.

gao.gov/t2pbat3/151585.pdf; Michael C. Durst, *Report of the Second Invitational Conference on Income Tax Compliance*, 42 TAX LAW. 705, 707 (1989).

⁷¹ See *Estate of Trompeter v. Comm'r*, 87 T.C.M. (CCH) 851, 875 (2004), *aff'd*, 97 A.F.T.R.2d 2006-1447 (9th Cir. 2006).

⁷² I.R.C. § 6019 (2002).

⁷³ See, e.g., Piroška Soos, *Self-Employed Evasion and Tax Withholding: A Comparative Study and Analysis of the Issues*, 24 U.C. DAVIS L. REV. 107, 113-20 (1990).

⁷⁴ Albeit upon the donor's death, the use of some or all of his lifetime gift tax exemption would result in a correspondingly higher estate tax burden.

Collusion is the final factor that contributes to the IRS's inability to detect noncompliance. The act of gift giving usually involves one person making a gratuitous asset transfer to a blood relative or other person of close kinship. The closeness of this relationship, as well as the recipient's gratitude, makes it unlikely that the recipient would act against the donor's interest. For example, recipients of gifts, hoping to accede to additional wealth in the future, are likely to assist in the noncompliance process by using gifted cash to pay for an expensive family vacation, for example, in order to avoid leaving an "asset trail." Alternatively, recipients may not sell a gifted asset for several years in order to cloud the gift's fair market value at the date of initial gift. Contrast the cooperative spirit between the gift giver and recipient with that between the typical employer and employee. In the latter relationship, the employer is usually inclined to be forthright in its reporting practices because it commonly doesn't have a sense of affinity with its employees such that it is willing to commit acts of indiscretion on their behalf.⁷⁵

2. The Inadequacies of the Existing Penalty Structure

On paper, taxpayers who file inaccurate gift tax returns by disregarding their gift tax filing obligations, or failing to pay the gift tax they owe, do so at great personal peril. The failure to accurately report the value of a gift is subject to an accuracy-related penalty of 20 percent on the amount of tax due,⁷⁶ the failure-to-file penalty is 5 percent per month on the amount of the gift tax due (up to a maximum percentage penalty of 25 percent),⁷⁷ and the failure to timely

⁷⁵ The collusive atmosphere that exists between donors and donees is far less likely to occur between an estate's representatives and an estate's beneficiaries. The probate or administration process usually involves many sets of eyes. For starters, when taxpayers die, usually a public record is made of their death; and, depending on governing state court rules, the value of the estate's assets must be disclosed. That is, compliance with the probate process is ordinarily fairly accurate because executors, personal representatives, and administrators do not want to run afoul of state court rules and procedures. In addition, in circumstances where an estate has multiple beneficiaries, each wants to make sure that he/she receives his/her fair share of the estate's assets and that no other beneficiary receives disproportionately more; in the estate administration process, informal and formal accountings are thus commonplace. As a result, in their tax reporting practices, an estate's executors are prone to be forthright to both estate beneficiaries and the government or risk either being surcharged for violation of their fiduciary duties or incurring delinquent tax penalties.

⁷⁶ See I.R.C. § 6662(b)(5) (applying the penalty when the value of any property claimed on a gift tax return is 65 percent or less of the amount determined to be correct); *see also* I.R.C. § 6662(h) (doubling the accuracy-related penalty to 40 percent in cases where the value of any property claimed on a gift tax return is 40 percent or less of the amount determined to be correct).

⁷⁷ I.R.C. § 6651(a)(1).

pay is subject to a 0.5 percent per month penalty on the amount of the tax due (up to a maximum percentage penalty of 25 percent).⁷⁸

But application of each of the foregoing penalties is predicated upon there being an actual gift tax due.⁷⁹ In the absence of a gift tax being due, there can consequently be no accuracy-related penalty, failure-to-file penalty, or failure-to-pay penalty. Thus, in a world where most taxpayers do not ordinarily make gifts that exceed their annual gift tax exclusion (currently, \$12,000) or their lifetime gift tax exemption of \$1 million, there is virtually no chance that any of the foregoing penalties will apply.

Therefore, even in those instances when the IRS uncovers gift tax filing noncompliance, it has virtually no incentive to pursue the matter. Again, because of the lifetime gift tax exemption of \$1 million,⁸⁰ there are few instances when taxpayers' gifts will yield immediate tax dollars (i.e., the aggregate amount of taxable gifts exceeds the taxpayer's lifetime gift tax exemption of \$1 million). A gift tax audit will thus ordinarily produce only two possibilities: (1) if and when the taxpayer makes additional taxable gifts sometime in the near or distant future, potential gift tax will be due; or (2) when the taxpayer subsequently dies one, two, three, four, or five decades down the road, the gift tax audit that resulted in the partial depletion of the taxpayer's lifetime gift tax exemption will result in the possibility of additional estate tax being due.⁸¹ These kinds of audit "payoffs" – in which the term *pay* is truly a misnomer – are unlikely to spur IRS personnel to be too vigilant in the audit process.

Consider the plight of a taxpayer who makes a significant gift, say \$500,000, in 2007; purposely fails to file a gift tax return; and, a decade or two later, conveniently "forgets" that he made this earlier gift. If the taxpayer makes another significant taxable gift (i.e., in excess of the annual gift tax exclusion), or, alternatively, the taxpayer dies and the taxpayer's executors fail to report this prior gift (perhaps because they themselves were unaware that this gift was ever made), the most likely outcome is that this taxpayer's selective amnesia will not be detected by the IRS.

Certainly, duplicitous taxpayers who egregiously flaunt the law deserve to be penalized. But even in the unlikely event that such transgressions are uncovered, the IRS's only recourse would be to assess a gift tax. In the vast majority of cases, however, no gift tax would actually be due (assuming the taxpayer had not used his lifetime gift tax exemption of \$1 million), and thus no penalties or interest would apply. Evident from this one example is that, as a result of their gift tax derelictions, taxpayers who are irresponsible or fraudulent will likely not suffer any grim repercussions.

⁷⁸ I.R.C. § 6651(a)(2).

⁷⁹ See operative language of the statutes cited *supra* notes 76-78.

⁸⁰ I.R.C. § 2505.

⁸¹ Due to the availability of the unlimited estate tax marital deduction, see I.R.C. § 2056(a), this deferral of transfer tax liability can sometimes exceed a half century or more.

Thus, as a practical matter, penalizing taxpayers who don't fulfill their gift tax obligations will be rare indeed. Even rarer will be those instances when criminal prosecutions relating to the gift tax would be undertaken because the government will hardly ever have sufficient evidence to prove that a taxpayer had the requisite mens rea to criminally defeat the gift tax. Consider further the fact that although even the failure to file a gift tax return when one is due constitutes a misdemeanor,⁸² there is not a single reported case where the IRS commenced a criminal indictment in the context of the gift tax.

The dearth of cases in which the IRS has successfully brought civil penalties and criminal sanctions reflects the sad state of affairs when it comes to the gift tax penalty structure. What are the implications of having a tax in place that lacks a viable penalty structure? The literature is replete with studies indicating that penalties function as a strong deterrent against taxpayer noncompliance.⁸³ These same studies likewise reveal a converse axiom: the absence of an effective penalty structure can undermine taxpayer compliance.⁸⁴ The practical implication of not having a penalty structure in place is that the gift tax is essentially a nullity.

In the end, the gift tax is concededly a counterintuitive tax. Taxpayers who make gifts do not expect to be burdened with paying a tax for engaging in such altruistic acts.⁸⁵ Indeed, few taxpayers appreciate the fact that the gift tax plays a critical role in the tax system and that without it, both the estate and income

⁸² I.R.C. § 7203; *see, e.g.*, *Bickham Lincoln-Mercury Inc. v. United States*, 168 F.3d 790, 793 (5th Cir. 1999) (holding that failure to file a form required for the receipt of cash is a criminal violation under I.R.C. § 7203).

⁸³ *See WHY PEOPLE PAY TAXES I* (Joel Slemrod ed., 1992) ("Stressing the importance of tax compliance and enforcement is not merely a technical point – it is a quantitatively important one."); Leandra Lederman, *The Interplay Between Norms and Enforcement in Tax Compliance*, 64 OHIO ST. L.J. 1453, 1453 (2003) ("[E]nforcement can buttress norms-based appeals for compliance."). Other commentators argue that social norms play a more important role in tax compliance than do tax penalties. Brian Erard & Jonathan S. Feinstein, *The Role of Moral Sentiments and Audit Perceptions in Tax Compliance*, PUB. FIN. PUBLIQUES 70, 71 (1994) ("[P]sychological theories suggest that moral sentiments, especially guilt and shame, may strongly influence [taxpayer] reporting behavior . . ."); James P.F. Gordon, *Individual Morality and Reputation Costs as Deterrents to Tax Evasion*, 33 EUR. ECON. REV. 797, 798 (1989) (positing that tax "evasion generates psychic costs incurred irrespective of whether the act of evasion is observed").

⁸⁴ *See generally* Michael G. Allingham & Agnar Sandmo, *Income Tax Evasion: A Theoretical Analysis*, 1 J. PUB. ECON. 323 (1972). This is, perhaps, one of the reasons why commentators sometimes refer to the estate tax as being voluntary in nature. *See* George Cooper, *A Voluntary Tax? New Perspectives on Sophisticated Estate Tax Avoidance*, 77 COLUM. L. REV. 161, 164 (1977) ("The fact that any substantial amount of tax is now being collected can be attributed only to taxpayer indifference to avoidance opportunities or a lack of aggressiveness on the part of estate planners in exploiting the loopholes which exist.").

⁸⁵ As such, if the IRS detects acts of noncompliance, taxpayers do not usually risk social ostracism.

tax systems would be at risk of being undermined. In the absence of a viable penalty system, counterintuitive taxes are particularly vulnerable to taxpayer noncompliance.⁸⁶ With respect to the gift tax, that is exactly the situation as it exists today.

C. *Reverse Alchemy and the Process of Making Wealth (Temporarily) Disappear*

In the sphere of estate planning, how does wealth temporarily disappear (for gift tax reporting purposes) and then miraculously reappear in the hands of donees?⁸⁷ One look at practitioners' journals reveals that most taxpayers, to minimize their gift tax obligations, are instructed to use one or more of the following planning techniques: (1) form a family limited partnership,⁸⁸ (2) establish a QPRT,⁸⁹ and/or (3) transfer rapidly appreciating property into a GRAT.⁹⁰ The long-standing stature of these techniques in the field of estate planning speaks loudly of their viability and success.

To illustrate the transfer tax-reducing power of each of these techniques, consider the options of an unmarried taxpayer who has \$5 million of assets, three adult children, and a desire to minimize her gift tax burdens.

⁸⁶ See Marjorie E. Kornhauser, *Doing the Full Monty: Will Publicizing Tax Information Increase Compliance?*, 18 CAN. J.L. & JURISPRUDENCE 95, 97 (2005) (indicating that where taxpayers perceive a tax as unjust, compliance will decline); Raskolnikov, *supra* note 61, at 577-78 ("[M]ost models suggest that nominal penalties and the probability of punishment play important roles in shaping taxpayer behavior.").

⁸⁷ Professor James Repetti creatively used the term "alchemy" to describe this process. James R. Repetti, *Minority Discounts: The Alchemy in Estate and Gift Taxation*, 50 TAX L. REV. 415, 416 (1995) ("A common tool of estate planning involves the purposeful diminution in value of family property in order to reduce estate and gift taxes. . . . [A] basic strategy involves dividing up control of an asset such as a business or real estate.").

⁸⁸ See, e.g., Edward M. Manigault & Charles E. Hodges II, *Valuation Discounts – An Analysis of the Service's Position Compared with Litigated Cases*, 91 J. TAX'N 26, 36 (1999) ("Therefore, unless the willing buyer / willing seller test in the Regulations is changed, discounts must continue to be allowed in valuing property interests because the discounts aid in properly measuring FMV."); Ira S. Feldman, *Ensure Family Limited Partnerships Work on All Fronts*, 75 PRAC. TAX STRATEGIES 226, 226 (2005) ("The professional 'buzz' is all about family limited partnerships."); James R. Hamill & Donald W. Stout, *Valuation Discounts for Intrafamily Transfers*, 59 TAX'N FOR ACCT. 75, 75 (1997) (pointing out that by structuring transfers through family limited partnerships, taxpayers can qualify for valuation discounts that produce significant gift tax savings).

⁸⁹ See, e.g., James R. Hamill, *Personal Residence Trusts Can Reduce Transfer Taxes*, 55 TAX'N FOR ACCT. 73, 79 (1995) (elaborating on why a personal residence trust "offers advantages over transfers of other types of property with retained income rights").

⁹⁰ See e.g., Carlyn S. McCaffrey et al., *The Aftermath of Walton: The Rehabilitation of the Fixed-Term, Zeroed-Out GRAT*, 95 J. TAX'N 325, 335 (2001) ("The fixed-term, zeroed-out GRAT is an extremely valuable estate planning tool for individuals who want to transfer property to family members without paying gift tax.").

The first option is that the taxpayer takes, say, \$3 million in marketable securities that she owns and contributes them to a newly formed family limited partnership in which she will hold a 99 percent limited partnership interest, with one of her children holding the 1 percent general partnership interest.⁹¹ The taxpayer would then make annual exclusion gifts of limited partnership interests to her children.⁹² For valuation purposes, because the limited partnership interests that are gifted represent a noncontrolling interest in the entity, a minority discount would be permitted (probably in the 15 percent to 25 percent range).

Next, the taxpayer could transfer her \$1 million personal residence into a QPRT. The terms of the QPRT specify that it is to exist for a term of twenty years. At the end of this twenty-year period, the assets of the QPRT will be held in trust for the benefit of the taxpayer's children until the taxpayer's death.⁹³ The transfer is made when the applicable federal rate is 7 percent. Under this set of assumptions, contributing title to her personal residence to the QPRT will result in a \$200,000 reportable gift.⁹⁴ No gift tax will be owed, however, because of the taxpayer's lifetime gift tax exemption.

Finally, the taxpayer establishes a GRAT.⁹⁵ The taxpayer will be the GRAT's sole trustee, and she will contribute her \$1 million of remaining assets. The GRAT is to exist for a two-year term,⁹⁶ and the annuity payout rate is set at \$555,833.30. Given these terms and the governing section 7520 rate of 7 percent, the value of the remainder interest passing to the taxpayer's

⁹¹ This is a similar structure to that used by the taxpayer in *Jones v. Commissioner*. See 116 T.C. 121, 121 (2001) ("D formed a family limited partnership (JBLP) with his son and transferred assets including real property, to JBLP in exchange for a 95.5389-percent limited partnership interest."). For a discussion of the *Jones* decision's continuing viability, see Gans & Blattmachr, *supra* note 50, at 11 ("In terms of planning, it is no longer prudent for taxpayers to rely on the holding in *Jones* . . .").

⁹² I.R.C. § 2503(b) (2002) (allowing, currently, a \$12,000 exclusion).

⁹³ Having these trust provisions essentially allows the taxpayer to reside in her personal residence as a trust beneficiary or as a rent-paying tenant for the balance of her life.

⁹⁴ The actual figure for a fifty-year-old taxpayer making such a gift is \$199,630. For heuristic reasons, we round up here.

⁹⁵ If it provides the reader of this paragraph any solace, most taxpayers who establish GRATs comprehend little about the intricacies of their operations, recognizing only the resultant gift tax savings such trusts offer.

⁹⁶ Some commentators have questioned whether a two-year GRAT is permissible in that, under Treas. Reg. §§ 25.2702-3(b)(1)(ii), (d)(3) (as amended in 2005), the annuity must be payable periodically and at least annually. This regulation could plausibly be read as requiring that the annuity be made payable for a period in excess of two years. *But see* Walton v. Comm'r, 115 T.C. 589, 604 (2000) ("[T]he qualified interest retained by petitioner in each GRAT here is an annuity payable for a specified term of 2 years."); Kerr v. Comm'r, 113 T.C. 449 (1999) (involving, like *Walton*, a short-term GRAT where the IRS did not challenge the validity of the strategy on this ground); I.R.S. Priv. Ltr. Rul. 92-39-015 (June 25, 1992) (approving a two-year GRAT).

children (which constitutes a taxable gift) is considered \$0. Therefore, as long as some GRAT principal remains at the end of its two-year term, it can pass free of gift tax to the taxpayer's children. For example, if the GRAT produces a 10 percent return of income and 10 percent growth on its assets, \$226,412.57 will remain for the trustee to distribute to the taxpayer's children at the end of the trust term.⁹⁷

An overall examination of these strategies illustrates the success of this reverse alchemy process. By utilizing this series of planning techniques – abracadabra! – the taxpayer could legitimately reduce her transfer-tax exposure.⁹⁸ The taxpayer's ability to magically transform her "gold" into coal is not considered overly aggressive estate tax planning; to the contrary, it is sanctioned under the Code⁹⁹ and by the courts.¹⁰⁰

In terms of enforcement, GRATs and annual exclusion gifts of family limited partnership interests are particularly problematic because there is no taxable gift being made and so gift tax returns may not even need to be filed. Moreover, in the case of a GRAT, even assuming a gift tax return is filed, there is very little risk that the IRS, on audit, could sustain a determination that the return undervalues the amount of the gift.¹⁰¹

⁹⁷ The taxpayer may repeat this GRAT contribution process every two years; thus, however an annuity amount is paid by the GRAT to the taxpayer (in this case, the two payments of \$555,833.30), the remainder is rolled back into a new two-year GRAT. See, e.g., Dan W. Holbrook & Daniel P. Murphy, *Two-Year, Overlapping GRATs Can Maximize the Benefits of Split-Interest Transfers*, 78 J. TAX'N 154, 158 (1993).

⁹⁸ Note, however, if the taxpayer dies during the term of the QPRT or the GRAT, some or all of the transfer tax savings associated with the use of these techniques may vanish. See *supra* note 55.

⁹⁹ I.R.C. §§ 2512, 2702 (2002).

¹⁰⁰ The discount for a minority interest accounts for the inability of a shareholder to control or influence decisions in a closely held corporation. See *Stevens v. Comm'r*, 79 T.C.M. (CCH) 1519, 1521 (2000) ("After determining the gross value of the property, there may be adjustments upward or downward for such factors affecting value as minority discounts, discounts for lack of marketability, control premiums, and fractional interest discounts."); *Ward v. Comm'r*, 87 T.C. 78, 106 (1986) ("The courts have long recognized that the shares of stock of a corporation which represent a minority interest are usually worth less than a proportionate share of the value of the assets of the corporation."). For discounts to account for a business interest's lack of marketability, see *Jones v. Comm'r*, 116 T.C. 121, 136 (2001) (allowing an 8 percent marketability discount on an 83.08 percent controlling interest); *Maggos v. Comm'r*, 79 T.C.M. (CCH) 1861, 1874 (2000) (allowing a 25 percent illiquidity discount on a 56.7 percent interest conveying effective operational control); *Hendrickson v. Comm'r*, 78 T.C.M. (CCH) 322, 339 (1999) (allowing a 30 percent marketability discount on a 49.97 percent effectively controlling interest).

¹⁰¹ In the case of a GRAT, the regulations surprisingly permit taxpayers to avoid a risk that they necessarily incur in all other forms of gift planning. The regulations provide that if the value of the transferred assets is ultimately determined to be greater than the amount reported on the gift tax return, the taxpayer is nonetheless deemed not to have made an additional taxable gift, provided that the instrument contains a valuation adjustment clause

Over the past three decades, the atmosphere in the Beltway toward the gift and estate taxes has largely been one of utter contempt.¹⁰² In the past several years, rarely a week has gone by that another elected representative hasn't called for the repeal of these transfer taxes.¹⁰³ This hostility toward transfer taxes (pejoratively labeled "death taxes") has likely translated into diminished

sanctioned under the regulations. See Treas. Reg. § 25.2702-3(b)(1)(ii)(B) (2005). The use of such a clause outside of the GRAT context is not permitted on public policy grounds by the courts. See *Procter v. Comm'r*, 142 F.2d 824, 827 (4th Cir. 1944) (striking down, on public policy grounds, a clause designed to defeat a gift if audited); *Ward v. Comm'r*, 87 T.C. 78, 116 (1986) (invalidating, on public policy grounds, a value-adjustment clause). But see *McCord v. Comm'r*, 461 F.3d 614, 623 (5th Cir. 2006) (upholding such a clause based on the government's failure to assert the public policy argument on appeal). For a discussion of value-adjustment clauses generally, see Diana S.C. Zeydel & Norman J. Benford, *Valuation Principles and Recent Developments: Practical Guidance for the Estate Planner*, 34 REAL PROP. PROB. & TR. J. 207, 236-61 (1999). While the Treasury decided to permit the use of value-adjustment clauses in a GRAT on the rationale that they are permitted in the charitable-remainder context, this was a critical mistake. First, while permitting taxpayers flexibility in the charitable context does make some sense, there is no justification for extending this flexibility to a GRAT, a vehicle used to transfer wealth to family members. Second, in permitting the use of these clauses in a GRAT, the regulations inappropriately confer an advantage on GRATs that is not enjoyed by outright gifts or other forms of transfer: while a taxpayer who makes an outright gift in order to secure the transfer-tax benefits of gifting must take the risk that, on audit, the IRS will determine that the gift was undervalued on the gift tax return, no such risk must be undertaken by taxpayers seeking the same benefits via a GRAT. Third, if a taxpayer can defeat the risk of an audit in this fashion and can also create the GRAT without reporting any taxable gift at inception, there is no downside risk inherent in the GRAT. If it performs (i.e., assets produce a return in excess of the section 7520 rate), wealth is moved from the taxpayer to her family members on a transfer-tax-free basis; and if it fails to perform, the assets conveyed to the GRAT are returned to the taxpayer without a resulting disadvantage. The only risk is that the GRAT will not produce any upside advantage should the grantor die during the annuity term. See *supra* note 55. And, fourth, in permitting these clauses, the regulations weaken the argument that the use of these clauses in non-GRAT contexts violates public policy. After all, if the Treasury itself explicitly authorizes their use, the argument that they are so odious that they should be struck down on public policy grounds, even though there is no explicit basis for such an argument in the Code, is weakened. Indeed, one is left to wonder whether the court's conclusion in *McCord* (that the IRS had waived the public policy argument) was in part driven by the Treasury's decision to embrace these clauses in the GRAT regulations. For all of these reasons, the Treasury should carefully consider amending the regulations to preclude taxpayers from using these clauses in their GRATs.

¹⁰² See generally Jane G. Gravelle & Steven Maguire, *CRS Updates Analysis of Estate and Gift Tax Economic Issues*, TAX NOTES TODAY, June 23, 2006, LEXIS, 2006 TNT 134-23; Nonna A. Noto, *CRS Updates Report on 109th Congress Estate Tax Bills*, TAX NOTES TODAY, July 31, 2006, LEXIS, 2006 TNT 162-15.

¹⁰³ See *supra* note 99 and accompanying text; see also Congressional Tax Correspondence, *Armed Summarizes Legislative Progress for House Republicans*, 91 TAX NOTES 451, 451 (2001) ("We've now voted to . . . repeal the immoral death tax.").

taxpayer compliance. After all, if those who govern have expressed such moral outrage at the supposed unfairness of transfer taxes, taxpayers would certainly feel justified in circumventing (or ignoring) their transfer tax obligations. The effect of these repeated calls for estate tax repeal and the closeness of the relationship between the gift tax and the estate tax have no doubt enervated IRS personnel who conduct gift tax audits and who know that the bounty of their work may ultimately prove hollow, particularly in the absence of a viable estate tax.

In light of the systemic problems that have beset the gift tax, the question thrust upon Congress's doorstep is not if something should be done, but rather what that something should be. Part III suggests appropriate reforms.

III. REFORMS TO REINVIGORATE THE GIFT TAX

Congress needs to reform the gift tax so that it can fulfill its historic missions of safeguarding the estate and income tax regimes. Failure to institute the appropriate reform measures not only destines the gift tax to founder but also jeopardizes the fate of the income and estate taxes. Congress should therefore (A) craft legislation to broaden the base of the gift tax and (B) institute better reporting and penalty systems to ensure improved taxpayer compliance.

A. *Broadening the Gift Tax Base*

Currently, the valuation process saps the gift tax of its vitality and relegates it to a largely voluntary tax. In reality, when it comes to gratuitous transfers, taxpayers will do everything in their power to preserve the value of the assets they intend to transfer to their loved ones. Conversely, for gift tax reporting purposes, taxpayers will use every conceivable stratagem to artificially diminish the value of such transferred assets (at least on a temporary basis). Given a choice between reality and artificiality, the former should trump the latter. Thus, Congress should eliminate (1) the use of valuation discounts and, (2) the latitude associated with various forms of trust instruments. By instituting these measures, Congress will allow facts, not fictions, to dominate the taxability of gratuitous transfers.

1. Elimination of Valuation Discounts

For gift tax return reporting purposes, the willing buyer / willing seller test accurately values assets such as publicly traded stocks, bonds, and the like. When it comes to valuing closely held business interests, however, absent a family attribution principle that accounts for the interrelationships between and among the donor and donees, strict adherence to this test results in unrealistically low values.

Suppose a taxpayer and her husband own 60 percent and 40 percent, respectively, of the outstanding membership interests of Highly Profitable, L.L.C., worth \$1 million. If the taxpayer decides to transfer a 10 percent membership interest in the limited liability company to her daughter, valued in

the taxpayer's hands at \$100,000,¹⁰⁴ it would seem appropriate, for gift tax reporting purposes, that the amount of the reported gift would be \$100,000. As previously indicated,¹⁰⁵ however, application of the willing buyer / willing seller test permits lack-of-control and marketability discounts so that the 10 percent membership interest would likely be valued anywhere between \$70,000 to \$30,000, depending upon how aggressively the taxpayer (or the taxpayer's advisor) discounts the membership interest.

Commentators have offered several sensible ways to refine the willing buyer / willing seller test in the context of family-controlled businesses (defined as those business interests that are not listed on a public exchange).¹⁰⁶ The one that appears to be the most practicable involves a series of three steps.

The first step would be to use a set of attribution rules akin to those in sections 267(b) and 318(a) to determine what the transferor owns, both directly and constructively (i.e., by means of attribution).¹⁰⁷ For example, for purposes

¹⁰⁴ The taxpayer's membership interest would equal 1,000,000 / 10 or \$100,000.

¹⁰⁵ See *supra* notes 35-36 and accompanying text.

¹⁰⁶ See, e.g., JOINT COMM. ON TAXATION, 109TH CONG., OPTIONS TO IMPROVE TAX COMPLIANCE AND REFORM TAX EXPENDITURES 396-404 (Comm. Print 2005), available at <http://www.house.gov/jct/s-2-05.pdf> (offering a proposal to limit the availability of minority and lack-of-marketability discounts through aggregation rules and a look-through rule) [hereinafter OPTIONS TO IMPROVE TAX COMPLIANCE]; Laura E. Cunningham, *FLP Fix Must Be a Part of Transfer Tax Reform*, 112 TAX NOTES 937 (2006) (advocating the approaches adopted in OPTIONS TO IMPROVE TAX COMPLIANCE and suggesting that even more aggressive measures be taken to curtail transfer tax valuation abuses). For many years, several commentators have been proponents of using a system of attribution for intrafamily gifts. See, e.g., Laura E. Cunningham, *Remember the Alamo: The IRS Needs Ammunition in Its Fight Against the FLP*, 86 TAX NOTES 1461, 1466 (2000) ("The attribution approach denies discounts for minority interests when the entity in question is controlled by the transferor or donee's family . . ."); Mary Louise Fellows & William H. Painter, *Valuing Close Corporations for Federal Wealth Transfer Taxes: A Statutory Solution to the Disappearing Wealth Syndrome*, 30 STAN. L. REV. 895, 900 (1978) (proposing "modifications to certain provisions of the Internal Revenue Code that will prevent individuals who fragment their ownership interests from frustrating the effectiveness of the federal transfer tax scheme"); Repetti, *supra* note 87, at 449 ("A judicial determination that the courts should examine the relationship of the transferees and other owners would not create an irrebuttable presumption, but rather would merely allow the courts to determine whether control will be exercised by the group.").

¹⁰⁷ If a family attribution principle were enacted, taxpayers would most certainly attack it on constitutional grounds. In *Land v. United States*, 303 F.2d 170, 172 (5th Cir. 1962), cert. denied, 371 U.S. 862 (1962), the Fifth Circuit suggested that the estate tax must be based on the value of the transferred interest that is in transit. To the extent that the tax is not so limited, the Fifth Circuit intimated that it might constitute a direct tax that violates Article I, Section 9, of the Constitution because it is not apportioned among the states on the basis of population. See *id.* at 172. In *Bright v. United States*, 658 F.2d 999, 1002-03 (5th Cir. 1981), the Fifth Circuit squarely rejected the IRS's family attribution argument after reviewing this aspect of its earlier analysis in *Land*. Thus, *Bright* could conceivably be cited

of valuing a taxpayer's interest in a business, a taxpayer would generally be deemed to own the interests held by his/her spouse, children, grandchildren, and parents. Depending upon several factors (e.g., remoteness of interest and proportion of ownership), business interests held by partnerships, trusts, estates, and corporations would likewise be deemed constructively owned by the taxpayer. The foregoing attribution rules would determine the taxpayer's actual and constructive ownership.

Next, the willing buyer / willing seller test would value, in the aggregate, the interests actually and constructively held by the taxpayer.

Finally, the value determined under the second step would be multiplied by a fraction, the numerator of which would equal the percentage interest of the business enterprise being gifted and the denominator of which would equal the taxpayer's actual and constructive ownership percentages in the business enterprise.

Consider how this proposed reform would operate. In the previous example, in addition to the 60 percent membership interest she actually owns, the taxpayer's husband's 40 percent membership interest would be attributed to her as well. The next step calls for application of the willing buyer / willing seller test, which would value at \$1 million the taxpayer's 100 percent membership interest (i.e., 60 percent owned directly plus 40 percent owned by family attribution) in Highly Profitable, L.L.C. As a final step, since the taxpayer is giving away a 10 percent membership interest, the appropriate gift tax figure would therefore be \$100,000 (\$1 million x 10 percent divided by 100 percent), keeping in mind that due to the taxpayer's controlling interest,

by taxpayers for the proposition that Congress may not constitutionally impose a family attribution principle. See, e.g., S. Stacey Eastland, *The Art of Making Uncle Sam Your Assignee Instead of Your Senior Partner: The Use of Partnerships in Estate Planning*, SK069 ALI-ABA 999, 1016 (2005) ("The [estate] tax cannot be a 'wealth tax' or 'property tax' on the intrinsic value of an asset to the decedent or donor at the time the transfer occurs; rather, it must be a tax only on the value transferred.").

The constitutional aspects of *Land* and *Bright* are, however, of questionable validity. In *Fernandez v. Wiener*, 326 U.S. 340 (1945), the Supreme Court held it constitutional to impose estate tax on the entire value of the shares of community property held by a husband and wife, even though, under state law, the surviving spouse's share was not transferred at the time of the decedent spouse's death (i.e., in *Fernandez*, the Court did not require application of the in-transit concept). Surprisingly, though, neither *Land* nor *Bright* cites *Fernandez*. Nor do these decisions explain how the in-transit valuation approach – that they suggest is constitutionally required – can be reconciled with the notion in *Fernandez* that value can be determined for transfer tax purposes based on a broader examination of the transaction. See *Jameson v. Comm'r*, 267 F.3d 366, 374-75 (5th Cir. 2001) (citing *Fernandez* but questioning the soundness of its reasoning); *Shepherd v. Comm'r*, 115 T.C. 376, 387 n.10 (2000), *aff'd*, 283 F.3d 1258 (11th Cir. 2002) (citing *Fernandez*); *Young v. Comm'r*, 110 T.C. 297, 313 (1998) (failing to cite *Fernandez*, but nonetheless accepting Congress's "power to levy a tax upon the occasion of a joint tenant acquiring the status of survivor at the death of the other joint tenant").

little or no marketability discount would be available.¹⁰⁸ Under the proposed methodology, the gift tax result would be the same even if the taxpayer initially held a 40 percent membership interest and her spouse held a 60 percent interest.¹⁰⁹

If Congress were to adopt the proposed set of attribution rules and institute the three-step valuation set forth above, minority discounts would be largely contained. Application of these attribution rules would also curb marketability discounts. Unlike minority discounts, marketability discounts are available even where the transferred interest is a controlling interest.¹¹⁰ However, as the size of the block increases, courts have almost universally held that the size of the marketability discount correspondingly decreases.¹¹¹ Thus, application of the proposed ownership attribution rules does double duty, restraining minority discounts as well as marketability discounts.¹¹²

In most instances, utilizing the proposed family attribution methodology will result in the appropriate gift tax valuation result. This is proven by the fact that after the taxpayer gifts the membership interest to her daughter, three scenarios are likely to ensue: (1) the taxpayer will continue to gift membership interests to her daughter; (2) the taxpayer and her spouse will both decide to sell all of their membership interests to an unrelated third party, in which case their daughter will likely join them in the sale; or (3) the taxpayer and her spouse will continue to hold their combined 90 percent membership interests until their respective deaths and then bequeath the balance of their membership interests to their daughter. *Ex post*, in each of these three scenarios,

¹⁰⁸ See *supra* note 35. For purposes of this illustration, we could also assume that one-third of Highly Profitable's assets are marketable, and, that being the case, a marketability discount would be precluded. See *infra* note 112.

¹⁰⁹ The taxpayer would again be deemed to own 100 percent of Highly Profitable, L.L.C., worth \$1 million. This value would be multiplied by a fraction, the numerator of which would be the percentage gifted (i.e., 10 percent) and the denominator of which would be the interest she actually and constructively owned (i.e., 100 percent).

¹¹⁰ See, e.g., *Curry v. United States*, 706 F.2d 1424, 1431 (7th Cir. 1983) (refusing to require that the jury be instructed to use the liquidation value as a floor in determining the value of a 53 percent stock interest).

¹¹¹ See, e.g., *Jones v. Comm'r*, 116 T.C. 121, 135 (2001) ("The owner of the 83.08-percent interest has the ability to persuade or coerce other partners into cooperating with the proposed sale.").

¹¹² Other commentators have suggested limiting the availability of marketability discounts in instances where a third or more of the business venture's assets (by value) consist of marketable assets (such as cash, stock, commercial paper, or the like). From a policy perspective, these commentators argue that the application of a marketability discount is inappropriate when the assets internally owned by a business venture are largely liquid. See *OPTIONS TO IMPROVE TAX COMPLIANCE*, *supra* note 106, at 402 n.897 (listing commentators); see also *Cloutier v. Comm'r*, 71 T.C.M. (CCH) 2001, 2004 n.5 (1996) (indicating that a marketability discount should not be substantial when valuing a 100 percent interest).

application of the suggested valuation approach makes sense because of the probability that the daughter will ultimately realize \$100,000 from holding her 10 percent membership interest in Highly Profitable, L.L.C. (assuming that, over time, the overall value of the limited liability company remains constant).

In a few cases, the suggested valuation approach will reach what some commentators would label an inappropriate outcome. Consider what would happen in the prior example in the unlikely event that the taxpayer and her spouse were to sell their remaining 90 percent membership interest to an unrelated third party without their daughter's consent or participation. No doubt engaging in this sale will significantly diminish the value of the daughter's membership interest in Highly Profitable, L.L.C., well below the reported \$100,000 gift tax figure; after all, the daughter will no longer have a meaningful voice in addressing business governance issues, and she will not have a ready market in which to sell her interest.

In this particular scenario, was it therefore misguided to have had the taxpayer who made this transfer to her daughter report a \$100,000 gift? For several reasons, as to both the taxpayer and her daughter, the answer to this question is no. First of all, in the vast majority of cases, donors will do everything in their power to engage in subsequent sales or exchanges that will enhance, rather than jeopardize, the asset values of previous gifts to their loved ones. However, even if such is not the outcome, the taxpayer should still report a \$100,000 gift. After all, the taxpayer's sale to an unrelated party described in the previous paragraph was a discretionary act on the part of the taxpayer. Rhetorically, one must therefore ask if these taxpayers have a legitimate right to complain if, in the aftermath of their choice, their daughter's limited liability company interest diminished in value. The daughter, too, must recognize that valuation declines are a regular commercial phenomenon and that whether the gifted membership interest is worth \$100,000 or some lesser figure, she nevertheless received a windfall.

In sum, valuation discounts are significantly eroding the gift tax base.¹¹³ Instituting legislation that would help eliminate this erosion would go a long way toward putting the gift tax back on solid footing.¹¹⁴

¹¹³ Such discounts significantly erode the estate tax base as well. See, e.g., *Church v. United States*, 85 A.F.T.R. 2000-804, 2000-809 to -810 (W.D. Texas 2000), *aff'd without published opinion*, 268 F.3d 1063 (5th Cir. 2001) (upholding, where a taxpayer transferred her ranch and publicly traded securities in return for a limited partnership interest in a newly formed limited partnership and died two days later, a 58 percent discount based upon the noncontrolling and illiquid nature of her business interest). To attain parity between the gift and estate taxes, the proposed valuation methodology should also be employed in valuing the decedent's assets for computation of the estate taxes owed. See *OPTIONS TO IMPROVE TAX COMPLIANCE*, *supra* note 106, at 396-404 (discussing valuation parity issues).

¹¹⁴ Aside from instituting the proposed set of attribution rules, Congress should also amend the Code to overrule cases involving entities that are established strictly with a tax avoidance motive in mind, see *supra* note 48, making the gift of an interest in such an entity ineligible for discounts unless the entity was formed for a substantial nontax purpose.

2. Treatment of Trust Contributions with a Retained Interest as Incomplete Gifts

GRATs and QPRTs are trusts that taxpayers establish with the sole purpose of effecting tax-free wealth transfers.¹¹⁵ Given the naked, tax-oriented objective of these trust instruments, Congress should eliminate their use.

Because taxpayers employ GRATs and QPRTs strictly as a means to defeat their transfer tax obligations and such trusts do not fulfill traditional trust goals (such as protecting the financial security of trust beneficiaries), Congress should revisit Code section 2702 and curb the use of these trusts.¹¹⁶ There is an easy way to accomplish this goal: treat any trust contribution in which the taxpayer holds a retained interest as an incomplete gift.¹¹⁷ Only at the point in time that the taxpayer's retained interest is extinguished would the gift be considered complete, and, for gift tax reporting purposes, an accurate value of the property actually being transferred could then be determined.

To illustrate, suppose a taxpayer establishes a two-year GRAT with a 55 percent annuity payout and contributes income-producing rental property worth \$1 million. The Code could treat this trust contribution as an incomplete gift, and thus no gift tax return would need to be filed. At the end of the two-year trust term, suppose the assets remaining in the GRAT after the annuity

¹¹⁵ Many forms of trusts are established for nontax purposes. *See supra* note 50.

¹¹⁶ Consider that federal transfer taxes only apply to the nation's wealthiest taxpayers. *See* Center on Budget Policy Priorities, *CBPP Examines Estate Tax Showdown*, TAX NOTES TODAY, June 5, 2006, LEXIS, 2006 TNT 107-94 (less than 0.5 percent of the overall taxpayer population is subject to the estate tax). Aside from potential transfer tax savings, there is no apparent reason why taxpayers in this wealth category would need (or want) to establish trusts with retained annuity or income rights therein.

¹¹⁷ Under the approach suggested in the text, the transfer is not deemed complete until the grantor's interest in the trust terminates. Such a late-completion rule is not, however, the only available solution. The problematic aspect of GRATs and QPRTs could also be remedied under an early-completion rule, under which all amounts contributed to a trust are immediately subject to gift tax. Thus, a grantor who created a GRAT or QPRT would be subject to gift tax on the entire value of the property conveyed to the trust, rather than the more limited value of the remainder interest as current law permits. For a discussion of these alternative approaches, see *GRIT's*, *GRAT's*, *GRUT's*, *supra* note 53, at 815-16 (discussing the alternative approaches). Interestingly, grantors could even be given an option to elect between these two rules; under current law, outside the context of QPRTs and GRATs, taxpayers are in effect permitted such an option, and no abuse or undervaluation results. That is, taxpayers can choose an outright gift, pay gift tax on the entire value of the gifted asset, and then exclude any postgift appreciation from the estate. In the alternative, taxpayers can structure a gift in trust so that no taxable gift occurs at inception, but the entire value of the trust's assets at the time of death is included in the estate. *See* I.R.C. §§ 2036(a)(2), 2038 (2002) (including date-of-death value of trust assets in the estate where the grantor has retained sufficient control to negate the gift tax at inception). As suggested, the same option could be extended to taxpayers who create GRATs and QPRTs without creating the potential for abuse.

payouts were worth \$500,000. This amount would constitute a gift and would have to be reported.

Like contributions to a GRAT, contributions to any form of trust in which the taxpayer holds a retained interest (such as a QPRT) would be considered incomplete and, for gift tax reporting, be held in abeyance until the taxpayer relinquished the retained interest she held in the contributed trust property.

Aside from treating trust contributions as incomplete, there are other options. The difficulty with GRATs is that taxpayers often effectively eliminate any gift-tax-associated risk by setting the annuity amount such that, when calculated at the time of funding, there would be a \$0 gift.¹¹⁸ Consider that if the assets in the GRAT produce a return in excess of the section 7520 rate, there is a gift and a transfer of wealth on a tax-free basis. Conversely, if the GRAT fails to produce such a healthy annual return, the GRAT returns all of its assets to the taxpayer who, although not able to effectuate a wealth transfer, is no worse off for engaging in this stratagem.

Suppose instead that at the time of the initial GRAT funding, a taxpayer, depending upon the amount of his trust contribution, had to pay a gift tax or exhaust all or a portion of his lifetime gift tax exemption amount. This rule would create an important deterrent: if the GRAT were to fail (i.e., its assets produced a rate of return equal to or below the section 7520 rate), the taxpayer would have paid gift tax or forfeited all or a portion of his lifetime gift tax exemption even though all the trust assets were returned to him and no gift was made.

Congress should mandate, at a minimum, that a particular percentage of any GRAT contribution be treated as a taxable gift. The Code could deem GRAT contributions, no matter how large the taxpayer's retained interest, taxable gifts equal to some percentage, say 10 percent, of the fair market value of the contributed assets.¹¹⁹ Instituting this requirement would infuse an element of risk into GRAT contributions (i.e., the value of the assets that remain in the GRAT after its term lapses may be less than 10 percent of the fair market value of the contributed assets), which could deeply hamper their attractiveness.¹²⁰

¹¹⁸ See *supra* note 58.

¹¹⁹ See I.R.C. § 2701(a)(4) (2002) (establishing a minimum-value rule in the context of a closely held business valuation); Dennis L. Belcher & Mary Louise Fellows, Task Force on Federal Wealth Transfer Taxes, *Report on Reform of Federal Wealth Transfer Taxes*, 58 TAX LAW. 93, 268 (2004) [hereinafter Task Report] (advocating this approach, relying, in part, upon I.R.C. § 2701).

¹²⁰ Most recently, with respect to charitable remainder annuity trusts, Congress instituted a similar requirement; now, a trust does not qualify as a charitable remainder annuity trust unless the value of the charitable remainder with respect to any transfer to the trust "is at least 10 percent of the initial net fair market value of all property transferred to the trust." I.R.C. § 664(d)(1)(D) (2002). There is no reason why Congress's success in the charitable area cannot be replicated in the sphere of gratuitous transfers made into trusts with respect to noncharitable beneficiaries.

Even if Congress fails to sponsor this initiative, the IRS may have sufficient leeway to itself promulgate regulations that achieve the same outcome.¹²¹

B. *Instituting a Functional Gift Tax Reporting and Penalty System*

A key part of any successful tax system is taxpayer compliance. Taxpayer compliance is not something that just happens, however; to the contrary, through various mechanisms, Congress must induce compliance. When it comes to transactions between family members, courts have repeatedly acknowledged that "heightened scrutiny" is required.¹²² The reason for such heightened scrutiny is that related taxpayers may unite to defeat their tax obligations. Like the courts, Congress has crafted many Code sections to preclude related taxpayers from conspiring to save taxes.¹²³ But even more action is needed. Given the fact that the vast majority of gifts are made between family members, there is every reason to assume that the courts and

¹²¹ In I.R.S. Tech. Adv. Mem. 2002-45-053, *supra* note 58, the IRS indicated that, under current law, a GRAT cannot be zeroed out, stating that it viewed "these gift arrangements as contrary to the principles of section 2702." In other words, even if the GRAT is structured to comply with *Walton*, the annuity is not a qualified interest if the remainder has a value of zero, because:

[F]or purposes of determining the value under sec. 2702, I.R.C., of the gift effected upon creation of each GRAT, P's retained qualified interest is to be valued as an annuity for a specified term of years, rather than as an annuity for the shorter of a term certain or the period ending upon P's death

115 T.C. 589, 589 (2000). As a result, the entire value of the assets conveyed to the GRAT would be subject to the gift tax. Unfortunately, neither the regulations nor the preamble contains a minimum-value rule with any specificity. Indeed, many practitioners apparently ignore this aspect of the TAM, although cautious practitioners are drafting their GRATs to minimize the risk that the TAM suggests.

The IRS might nevertheless adopt a general rule to the effect that a GRAT cannot be zeroed out, reflecting the notion that the section itself did not anticipate that GRATs could be zeroed out. It might then create a safe-harbor exception, under which the IRS would not question the validity of the GRAT (i.e., the retained annuity would be treated as a qualified interest if the remainder had a value of, say, 10 percent of the value of the assets conveyed to the GRAT). While such a regulation, issued more than fifteen years after the enactment of section 2702 might have been suspect at one time, regulations are no longer vulnerable simply because they were not issued contemporaneously with the enactment of the statute. See *Smiley v. Citibank*, 517 U.S. 735, 740 (1996) (holding that a "100-year delay makes no difference. . . . [N]either antiquity nor contemporaneity with the statute is a condition of validity").

¹²² See, e.g., *Kimbell v. United States*, 371 F.3d 257, 265 (5th Cir. 2004) ("[W]hen the transaction is between family members, it is subject to heightened scrutiny . . ."); *Comm'r v. Culbertson*, 337 U.S. 733, 746 (1949) ("[The] existence of the family relationship does not create a status which itself determines tax questions, but is simply a warning that things may not be what they seem.").

¹²³ See, e.g., I.R.C. § 267 (2002) (disallowing losses on asset sales between related parties).

Congress should exercise maximum vigilance. Two ways to exercise such vigilance are for Congress to institute (1) a meaningful reporting regime, and (2) a penalty structure that has some backbone.

1. Institute a Meaningful Reporting System

A recent example of where Congress took measures to improve taxpayer compliance through a reporting system is in the area of tax shelters. Congress instituted disclosure requirements that require material advisors¹²⁴ to issue a return with respect to any reportable transaction (including so-called "listed transactions").¹²⁵ Likewise, taxpayers who are participants in these "reportable events" are required to file disclosure statements with their tax returns.¹²⁶ By instituting these requirements, Congress spoke boldly: illegitimate tax shelters are not to be tolerated.¹²⁷ In contrast, when it comes to fostering compliance with the gift tax, Congress has barely uttered a peep.¹²⁸

If Congress wants to switch course and have taxpayers take their gift tax return obligations seriously, it should consider the fact that third-party information returns have a proven track record of success in instilling taxpayer

¹²⁴ This is a person who provides any material aid, assistance, or advice with respect to organizing, managing, promoting, selling, implementing, insuring, or carrying out any reportable transaction, *see infra* note 125, and who directly or indirectly derives gross income in excess of a threshold amount (or such other amount prescribed by IRS) for that assistance or advice. I.R.C. § 6111(b)(1)(A) (2002).

¹²⁵ A "reportable transaction" is generally a transaction of a type that the IRS determines as having a potential for tax avoidance or evasion. *See* I.R.C. § 6707A(c)(1) (2002). The term *listed transaction* "means a reportable transaction which is the same as, or substantially similar to, a transaction specifically identified by the Secretary as a tax avoidance transaction." I.R.C. § 6707A(c)(2). For an exhaustive discussion of reportable transactions, *see generally* JONATHAN G. BLATTMACHR, MITCHELL M. GANS & DAMIEN RIOS, *THE CIRCULAR 230 DESKBOOK* ch. 3 (2006).

¹²⁶ Taxpayers are instructed to use a Form 8886 (Reportable Transaction Disclosure Statement) to disclose tax shelter reportable transactions. *Treas. Reg.* § 1.6011-4(d) (as amended in 2006).

¹²⁷ Tax shelter participants who are noncompliant face harsh penalties. Noncompliant marketers of such shelters, for example, must bear a \$50,000 penalty for each failure to disclose. I.R.C. § 6707(b)(1). However, if the failure relates to a "listed transaction," the penalty is the greater of (1) \$200,000 or (2) 50 percent of the gross income received by the material advisor that is attributable to "aid, assistance, or advice" provided for the listed transaction before the date that the advisor files an information return that includes the transaction. I.R.C. § 6707(b)(2). A penalty structure of a similar nature applies to taxpayer participants who fail to make adequate disclosures. I.R.C. § 6707A (2002).

¹²⁸ *See* Dustin Stamper, *IRS, Estate, Gift Tax Compliance Efforts Refocusing on Nonfilers*, *TAX NOTES TODAY*, June 20, 2006, LEXIS, 2006 TNT 118-2 ("[N]ew IRS estimates reveal that estate and gift tax nonfilers are responsible for a significant portion of the tax gap.").

compliance with respect to the income tax.¹²⁹ That being the case, Congress should extend third party reporting requirements to the sphere of the gift tax. In the paragraphs that follow, we outline the reporting system we have in mind.

Whenever a nonspousal donee receives a taxable gift (i.e., a gift that exceeds the gift tax annual exclusion or that does not qualify for medical or tuition exclusions),¹³⁰ the donee would have to file an information return. Furthermore, if the donee receives multiple gifts from the same donor, the aggregate value of which during any calendar year exceeds the gift tax annual exclusion, the donee would likewise have to file an information return. The proposed information return would delineate the names of the donor and donee, a description of the property gifted including its tax basis, the date of the gift, and the fair market value of the gifted property. The scope of this reporting obligation would include contributions to irrevocable trusts in which the donor made completed gifts; that is, trustees of such trusts would be obligated to report trust contributions that are subject to gift tax.¹³¹ Bolstered by receipt of these information returns, the IRS would be far better situated to check the accuracy of donors' gift tax returns (i.e., Form 709).

Is third-party information return reporting such as the kind suggested in the prior paragraph administratively feasible? There is evidence that this process can work. Indeed, such a requirement is already in place with respect to the receipt of gifts and bequests from foreign individuals as well as distributions made from foreign trusts. Under current law, if a foreign donor makes a sizable gift or bequest (i.e., in excess of \$100,000) to a U.S. taxpayer or resident alien,¹³² the donee must report the receipt of such gift or bequest on a Form 3520.¹³³ A similar rule applies in cases where a foreign trust makes a distribution to a U.S. taxpayer or resident alien.¹³⁴ Based on the success of the path already established with respect to foreign gifts and bequests and trust distributions, there is no reason why a similar reporting obligation could not be

¹²⁹ See *supra* notes 70-74 and accompanying text.

¹³⁰ See *supra* notes 26-28 and accompanying text.

¹³¹ This reporting obligation could also be extended to other entities, such as partnerships and corporations in which donors have the opportunity to make indirect gifts. To limit the administrative burden associated with this augmented attribution rule, it would only apply in those instances in which the taxpayer directly or constructively (via attribution rules) owned more than 50 percent of the entity in question.

¹³² I.R.S. Notice 97-34, 1997-1 C.B. 422, 431 ("Gifts from foreign individuals and foreign estates."). For tax years beginning in 2006, the reporting threshold amount is \$12,760 in the case of gifts from foreign corporations and foreign partnerships. Rev. Proc. 2005-70, 2005-47 I.R.B. 979, 985.

¹³³ I.R.C. § 6039F(a) (2002) ("[S]uch United States person shall furnish (at such time and in such manner as the Secretary shall prescribe) such information as the Secretary may prescribe regarding each foreign gift received during such year.").

¹³⁴ I.R.C. § 6048(a) (2002).

put into place for recipients of gifts made by U.S. taxpayers.¹³⁵ Broadening this third-party reporting requirement to include all gifts – foreign or domestic – would probably be the most effective way to give the gift tax “traction” in the area of taxpayer compliance.

Some commentators, however, would likely lament the institution of this third-party reporting requirement. Why? They would argue that this reporting requirement puts recipients in the uncomfortable position of having to “tattle” on donors. Put differently, does Congress really want to have taxpayers’ children (the recipients of most taxable gifts) serve as an enforcement arm of the IRS? Rejecting this reporting requirement as overly intrusive miscasts its essence, however, which is simply to check and confirm.

Notably, a similar complaint of intrusiveness was lodged against a proposal authored by an IRS research officer who, in the early 1980s, suggested taxpayers claiming their children as dependents provide the children’s social security numbers.¹³⁶ At the time, there was an anguished outcry that this requirement was too Big Brother in nature. Congress nevertheless heeded the IRS research officer’s recommendation, and “seven million dependents . . . suddenly vanished from the tax rolls,” generating an additional \$3 billion of revenue annually.¹³⁷ The filing requirement we envision is no more intrusive than the disclosure of a dependent’s social security number or the litany of detailed information returns taxpayers are already required to file.¹³⁸

If, however, the issuance of third-party information returns is considered too intrusive in nature and therefore politically untenable, there is at least one viable alternative. As a stand-alone alternative (or as a complement to the information return reporting proposal we outlined above), Congress should require taxpayers on their income tax returns (Form 1040s) to affirmatively answer the following yes-or-no question: During the course of the prior calendar year, did you make or receive gifts from another taxpayer that

¹³⁵ If the recipient of a foreign gift fails to report it, Congress imposes a penalty of 5 percent of the amount of the gift for each month that the failure continues, up to a maximum penalty of 25 percent. I.R.C. § 6039F(c)(1)(B) (2002). A somewhat similar penalty applies in those cases in which a U.S. taxpayer or resident alien fails to report the receipt of a foreign trust distribution. See I.R.C. § 6677(a) (2002) (imposing a penalty “equal to 35 percent of the gross reportable amount”; in addition, if any failure to file continues for more than ninety days after the day on which the IRS mails a notice of failure to file to the person responsible for the penalty, that person must pay an additional penalty of \$10,000 for each thirty-day period (or fraction thereof) during which the failure continues, not to exceed the gross reportable amount).

¹³⁶ Stephen J. Dubner & Steven D. Levitt, *Filling in the Tax Gap: Why Americans Should be Clamoring for the IRS to Do More Audits, Not Fewer*, N.Y. TIMES MAG. (Apr. 2, 2006) (discussing how IRS research officer John Szilagyi led the crusade to get this oversight mechanism into place).

¹³⁷ *Id.*

¹³⁸ See *supra* notes 70-74 and accompanying text.

exceeded \$X (i.e., the annual gift tax exclusion) and that did not qualify for the medical and educational payment exclusions?¹³⁹

In responding to this yes-or-no question, a taxpayer who made or received a gift and did not want to report it would be required to affirmatively lie. Given the greater psychological discomfort that people typically experience when affirmatively lying, as compared to lying by omission,¹⁴⁰ a question of this sort would likely induce more taxpayers to fulfill their gift tax return filing obligations.¹⁴¹

2. Institute a Meaningful Penalty System

Another reform measure necessary to induce taxpayer compliance is the institution of a meaningful penalty system. Penalties would apply in instances when taxpayers fail to timely file their gift tax returns or when taxpayers significantly underreport the amount of their gifts. The structure of the penalty system could mirror the one already in place with one important difference: for purposes of computing penalty amounts, it would ignore the availability of a taxpayer's \$1 million lifetime gift tax exemption.

The specifics of the proposed penalties are as follows. For every month taxpayers are delinquent in filing their gift tax returns, they would face a failure-to-timely-file penalty of 5 percent per month (up to a 25 percent maximum); in instances when taxpayers underreported the amount of their gifts, they would bear an accuracy-related penalty of 20 percent.¹⁴² Neither of these penalties would be calibrated based upon the amount of the gift tax *actually due* (which is often zero because of the donor's \$1 million lifetime gift tax exemption).¹⁴³ Instead, penalties would be computed based upon the amount of gift tax that would be *hypothetically due* assuming the taxpayer had already exhausted his or her \$1 million lifetime gift tax exemption. Were Congress to institute a penalty structure formulated in this fashion, taxpayers would have to be wary of their derelictions, knowing that they might prove

¹³⁹ See Task Report, *supra* note 119, at 122-24 (pointing out the need to ask donors a question on the Form 1040 but overlooking the need to ask the same question to donees).

¹⁴⁰ See *Spies v. United States*, 317 U.S. 492, 499 (1943) (expressing the opinion that passive neglect of a statutory requirement is usually less offensive than active violation of a statutory duty); Brian J. Sullivan & Jessica L. Thorn, *Tax Violations*, 43 AM. CRIM. L. REV. 991, 1004-06 (2006) (describing the state of mind necessary to trigger a criminal violation).

¹⁴¹ See PAUL EKMAN, *TELLING LIES, CLUES TO DECEIT IN THE MARKETPLACE, POLITICS, AND MARRIAGE* 29 (1985) ("[L]iars may feel less guilt about concealing than falsifying."). The same distinction is often made in the fraud context. See, e.g., 2 RESTATEMENT (THIRD) OF PROPERTY: WILLS & DONATIVE TRANSFERS § 8.3 cmt. j (1983) (indicating that, as a general rule, a finding of fraud requires an active misrepresentation rather than passive concealment).

¹⁴² See I.R.C. §§ 6651, 6662 (2002) (delineating the failure-to-timely-file penalty and the accuracy-related penalty).

¹⁴³ See I.R.C. § 2505 (2002) ("Unified credit against gift tax.").

costly. Interest on these proposed penalties would begin to accrue at the due date for the return.¹⁴⁴

To illustrate how these proposed penalties would operate, suppose a taxpayer gifted \$500,000 worth of stock in a closely held business to his son. Suppose further that the taxpayer failed to timely file a gift tax return and that three months after the due date of the gift tax return, the taxpayer fulfilled his filing obligation but negligently reported the value of the gift to be \$300,000 rather than \$500,000.

In this example, both the failure-to-timely-file and the accuracy penalties would apply. This is true even though the taxpayer was not liable for actually paying a gift tax because his yet unused lifetime gift tax exemption was sufficient to shelter this transfer from gift tax. As proposed, the failure-to-timely-file penalty would equal \$33,750 (i.e., \$225,000 (the amount of gift tax levied upon a \$500,000 gift using the current gift tax rate of 45 percent) x .15 (5 percent per month for each delinquent month x 3)). In addition, an accuracy-related penalty would be imposed equal to \$18,000 (i.e., \$200,000 (the underreported amount of the gift (\$500,000 - \$300,000)) x 45 percent (the 2007 gift tax rate) x .20). Interest on both of these penalties would commence on the due date of the gift tax return.

Furthermore, if Congress were to institute the proposed yes-or-no question on the face of the Form 1040 regarding the delivery or receipt of a gift,¹⁴⁵ a penalty of a different sort could be instituted. In cases in which the donees failed to answer this question or did so incorrectly, Congress could deny the gift's tax-exempt stature under Code section 102(a), thereby making the fair market value of such gift taxable income to the donee under Code section 61.¹⁴⁶ In cases where the donors failed to answer this yes-or-no question or did so incorrectly, Congress could impose a penalty on the donor equal to the fair market value of the gift times the applicable gift tax rate (which is currently a flat 45 percent).

These proposed penalties would likely be taken far more seriously by taxpayers than the mirage-like system currently in place. Once instituted, taxpayers would have to think twice before they scoffed at their gift tax return filing obligations. And that is exactly the way a meaningful penalty structure should function.

The modest reforms proposed in this paper will not cure all the ills affecting the overall health of the gift tax. However, they are the most easily instituted, offer the greatest return, and should be politically palatable. Other reforms deserve serious consideration, too (in particular, the need to eliminate the

¹⁴⁴ I.R.C. § 6601(e)(2)(B) (2002).

¹⁴⁵ See *supra* Part III.B.1.

¹⁴⁶ Were this suggestion instituted, Congress would also have to consider extending the statute of limitations to adjust the donee's income tax return to capture the income that would now be taxable. See I.R.C. § 6501 (2002).

manipulation of grantor trust status to effectuate transfer tax savings).¹⁴⁷ Congress, though, should consider implementing these other reforms

¹⁴⁷ Among the several ways taxpayers commonly circumvent their transfer tax obligations is to engage in the practice of selling their appreciating assets to so-called grantor trusts. For income tax purposes, the Code ignores the existence of these trusts and generally treats the grantor as the owner of the trust assets. See generally BRYLE M. ABBIN, *INCOME TAXATION OF FIDUCIARIES AND BENEFICIARIES* ch. 14 (2006) (discussing the tax considerations involved in estate planning). Here's how this tax stratagem works: a taxpayer makes a gift into a grantor trust equal to at least 10 percent of the value of an asset that is to be purchased by the trust (this is done to show the IRS that the trust has sufficient assets to make an adequate down payment). The trustee of the grantor trust then agrees to purchase a targeted asset from the taxpayer, using as consideration the property it recently acquired (via the initial gift) plus an installment note. Because of the grantor status of the trust, the asset sale does not constitute a recognition event to the taxpayer. Rev. Rul. 85-13, 1985-1 C.B. 184. Furthermore, on a going-forward basis, the taxpayer continues to be taxed on the income the grantor trust generates because, under the Code:

[T]here shall . . . be included in computing the taxable income . . . of the grantor . . . those items of income . . . which are attributable to that portion of the trust to the extent that such items would be taken into account under this chapter in computing taxable income or credits against the tax of an individual.

I.R.C. § 671 (2002). This ongoing income tax payment responsibility effectively allows the trust assets to grow tax-free (a benefit that inures to the trust beneficiaries) and depletes the taxpayer's estate (a benefit that reduces the taxpayer's ultimate estate tax burden). See generally Thomas C. Baird, *A Potpourri of Leverage Transfers Using Defective Grantor Trusts*, SG020 ALI-ABA 661 (2001) (describing the myriad ways taxpayers can manipulate grantor trust status to defeat their transfer tax obligations); Mitchell M. Gans, Stephanie E. Heilborn & Jonathan G. Blattmachr, *Some Good News About Grantor Trusts: Rev. Rul. 2004-64*, 31 EST. PLAN. 467 (2004) (same).

There are several ways Congress could eliminate the problem of taxpayers manipulating grantor trust status to defeat their gift and estate tax obligations. One possibility is that Congress could provide that in the case of an installment sale to a related party, see *supra* note 107 and accompanying text, any note received by a party related to the seller is to be treated as a retained interest in the assets sold. Thus, only when the note is completely discharged would the seller be deemed to have made a completed gift equal to the excess of the value of the assets at that time over the amounts previously received on the note. Consider the case of a taxpayer who sold a \$1 million piece of real estate to her daughter in return for a ten-year, \$100,000 installment note. By year ten, assume the value of the real estate had appreciated to \$2.5 million; were that the case, in year ten, after the note had been satisfied, the taxpayer would be deemed to have made a \$1.5 million gift to her daughter (i.e., the excess of \$2.5 million less the \$1 million she received in payments).

Another possibility would be to reform the grantor trust rules so that they would not be subject to such easy taxpayer manipulation. See generally Jay A. Soled, *Reforming the Grantor Trust Rules*, 76 NOTRE DAME L. REV. 375 (2001).

A final possibility would be to make the income tax rules related to grantor trust status consistent with the gift and estate tax rules. See generally Robert T. Danforth, *A Proposal for Integrating the Income and Transfer Taxation of Trusts*, 18 VA. TAX REV. 543 (1999). The IRS, too, might take curative action in the form of administrative regulations that apply

simultaneously with or after imposition of the more modest and necessary reforms proposed in this paper.

CONCLUSION

Because the gift tax raises virtually no revenue, it is a tax that Congress might rather ignore. Indeed, taxpayers are apt to do the same, but for a different reason: when it comes to gift giving, rather than being saddled with a tax or a reporting obligation, many taxpayers believe that they should be commended for their altruism.¹⁴⁸

Given the historical roots of the gift tax – namely, to safeguard the integrities of the income and estate taxes, which are significant revenue generators¹⁴⁹ – Congress ignores the gift tax to the possible peril of the nation's financial solvency. After all, if the gift tax is at risk of being easily circumvented, then, by axiom, so too are the other two taxes it guards. Certainly, taxpayers who are in the financial position to make significant

Code sections 2702 and 2036 to these installment sale arrangements: more specifically, for purposes of section 2702, the installment note would be viewed as a retained interest, causing it to be disregarded for gift tax purposes; and under Code section 2036, the assets sold to the trust would be included in the seller's estate if the note were still outstanding at the time of the seller's death. See I.R.S. Priv. Ltr. Rul. 95-35-026 (May 31, 1995) (ruling that Code section 2702 did not apply to an installment sale but stating that it would apply if it were ultimately determined that the note, in substance, was equity; and refusing to rule on whether, upon the seller's death, the assets sold to the trust would be subject to section 2036).

Dicta found in *Fidelity-Philadelphia Trust Co. v. Smith*, 356 U.S. 274 (1958), is relevant to these arguments. Under these dicta, in the case of a sale for a private annuity, the seller is not deemed to retain an interest in the assets sold provided three conditions are met: the obligation to make the annuity payments is a personal obligation of the transferee, the obligation is not chargeable to the property conveyed, and the amount of the annuity is not a function of the income produced by the property conveyed. See *id.* at 281 n.8 (listing the three conditions). Thus, assuming these conditions are met, Code section 2036 does not apply. As a result, the assets sold in the annuity transaction are not included in the seller's estate. The IRS has conceded that in analyzing installment sales and private annuity transactions, this dicta is controlling. See Rev. Rul. 77-193, 1977-1 C.B. 273. However, since these dicta do not suggest that the Code unambiguously precludes the seller from being viewed as having retained an interest in the assets sold, a regulation that overrules the dicta would be valid. See Mitchell M. Gans & Jay A. Soled, *A New Model for Identifying Basis in Life Insurance Policies: Implementation and Deference*, 7 FLA. TAX REV. 569, 601-04 (2006) (discussing *National Cable & Telecommunications Ass'n v. Brand X Internet Services*, 545 U.S. 967 (2005), under which even Supreme Court holdings can be overruled by regulation where the Code is ambiguous).

¹⁴⁸ For a detailed analysis of the complex motives that underlie donative transfers, see generally Eric A. Posner, *Altruism, Status, and Trust in the Law of Gifts and Gratuitous Promises*, 1997 WIS. L. REV. 567 (discussing different motives for giving gifts).

¹⁴⁹ See *supra* notes 8-23.

wealth transfers must recognize that there is a price (in the form of a transfer tax) associated with the privilege of gift giving.

Sometimes problems lack solutions; fortunately, this is not one of those situations. To the contrary, opportunities are readily at hand to restore integrity to the gift tax and, by doing so, the other taxes it protects. There are two keys to restoring integrity to the gift tax. The first is to broaden the base of the gift tax by putting proper valuation mechanisms in place and eliminating abusive forms of trust instruments. The second is to institute reporting mechanisms that facilitate IRS oversight and a penalty system that taxpayers will think twice about before violating.

The reforms proposed herein do not constitute a tax increase. Rather, they will help ensure that the gift tax will function in a manner consistent with its historic underpinnings. Politicians of all political persuasions should therefore welcome these reforms.

