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January 2003

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### Recommended Citation

Henry J. Lischer, *Incomplete Transfer Tax Repeal: Should the Gift Tax Survive*, 56 SMU L. REV. 601 (2003)  
<https://scholar.smu.edu/smulr/vol56/iss1/22>

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# INCOMPLETE TRANSFER TAX REPEAL: SHOULD THE GIFT TAX SURVIVE?

*Henry J. Lischer, Jr.\**

## I. INTRODUCTION

I have been invited to provide a response to the article of Professor Dodge.<sup>1</sup> Professor Dodge's article has prompted me to think further about an issue related to, but not directly raised in, his article: the apparent inconsistency of retention of the gift tax in an otherwise transfer-tax-free environment as a result of 2001 legislation that repealed (after December 31, 2009) the estate tax and the generation-skipping transfer tax.<sup>2</sup> In the relatively limited time allowed for preparation of this comment, I have been able to identify, but not fully develop or evaluate (let alone vet), some of the issues associated with this seemingly incongruent retention of the gift tax.

I provide below a brief review of events leading up to the 2001 legislation that eventually repeals the estate tax and the generation-skipping transfer tax. Congress chose to retain the gift tax, however, and retention of the gift tax was due, at least in part, to some widely discussed allegations that the absence of a gift tax would encourage income-shifting transactions that would lead to significant federal income tax revenue losses. I review the income-shifting techniques that have been proffered as viable if there were no gift tax. Thereafter, I discuss possible methods of combating inappropriate income shifting within the income tax, rather than relying on the gift tax.

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\* Professor of Law, Southern Methodist University.

1. See Joseph M. Dodge, *Comparing a Reformed Estate Tax with an Accessions Tax and an Income-Inclusion System, and Abandoning the Generation-Skipping Tax*, 56 SMU L. REV. 551 (2003).

2. The Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16 § 501, 115 Stat. 38, 69. Because this legislation substantially reduced federal tax revenues, and in order to comply with other budget legislation previously adopted by the Congress, all of the transfer tax provisions of the 2001 legislation do not apply after December 31, 2010. *Id.* § 901(a)(2), at 115 Stat. 150. Accordingly, in the unlikely event that no further legislation is enacted into law, the Internal Revenue Code provisions changed by the 2001 legislation will revert after December 31, 2010, to their status before the 2001 legislation. *Id.*

## II. BACKGROUND

## A. ROLE OF TRANSFER TAXES

Transfer taxes, in at least some political systems, have been part of the human condition for a very long time; they date back to 700 B.C. in Egypt, and to Caesar Augustus in Rome.<sup>3</sup> Transfer taxes have been present in the United States since 1797 in various forms and at various times.<sup>4</sup> The modern estate tax first was enacted without a gift tax,<sup>5</sup> but such an estate-tax-only tax system largely assures that decedents will die poor by making lifetime tax-free gifts. Eventually Congress was persuaded that a gift tax was necessary to assure the effectiveness of the estate tax.<sup>6</sup> The initial adoption of a gift tax in the United States was to serve explicitly as a backstop to the estate tax, but interestingly for purposes of this article, it was to serve as a backstop to the income tax as well.<sup>7</sup>

Recent years have seen Congress approve legislation to repeal the transfer tax system,<sup>8</sup> but President Clinton vetoed the legislation,<sup>9</sup> and Congress did not override the veto.<sup>10</sup> The election of President George W. Bush in 2000 created a new political scene, and congressional deliberations over transfer tax repeal began again with the active support of the Bush White House, which had declared repeal of the “death tax” as its top domestic priority. The stunning success of the 2001 repeal effort is a case study in the very effective exercise of political power by a very small but influential segment of the population (approximately two percent of all estates were subject to the estate tax before the repeal legislation).<sup>11</sup> The supporters of the transfer tax system eventually conceded the need to

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3. Tom Herman, *A Change in Death & Taxes? Debating the Options for an Estate-Tax Overhaul*, WALL ST. J., Feb. 26, 2001, at C1.

4. *Id.*

5. The estate tax was enacted by Revenue Act of 1916, Pub. L. No. 64-271, 39 Stat. 756, 777.

6. The first federal gift tax was enacted by the Revenue Act of 1924, Pub. L. No. 68-179, § 319 *et seq.*, 43 Stat. 253, 313. The current gift tax was enacted by the Revenue Act of 1932, Pub. L. No. 72-154, § 501 *et seq.*, 47 Stat. 169, 245 (1932).

7. See Wendy C. Gerzog, *Contingencies and the Gift Tax*, 93 TAX NOTES 977, 983-84 n.80 (2001); John Buckley, *Estate and Gift Taxes: What Will Congress Do Next?*, 91 TAX NOTES 2069, 2070 (2001) [hereinafter Buckley, *Estate and Gift Taxes*]; John Buckley, *Transfer Tax Repeal Proposals: Implications for the Income Tax*, 90 TAX NOTES 539 (2001) (referring to Chair of House Ways and Means Committee in 1924, when Congress was considering adoption of the modern gift tax, stating that gift tax was a backstop to the income tax) [hereinafter Buckley, *Transfer Tax Repeal Proposals*].

8. Death Tax Elimination Act of 2000, H.R. 8, 106th Cong. § 1 (2000); Taxpayer Refund and Relief Act of 1999, H.R. 2488, 106th Cong. § 601 (1999).

9. Death Tax Elimination Act of 2000 – Veto Message from the President of the United States, 146 CONG. REC. H7240 (daily ed. Sept. 6, 2000); Taxpayer Refund and Relief Act of 1999 – Veto Message from the President of the United States, 145 CONG. REC. H8613 (daily ed. Sept. 23, 1999).

10. 146 CONG. REC. H7335 (daily ed. Sept. 7, 2000) (Vote Roll No. 458, failing to override veto 274-157-4); 145 CONG. REC. H8614-8621 (daily ed. Sept. 23, 1999) (sending the 1999 veto to committee).

11. See Joel Friedman & Lee Andrew, *Estate Tax Repeal Would be Costly, Yet Benefit Only a Few*, 95 TAX NOTES 1984, 1987-88 (2002).

restrict the scope of the transfer taxes (by increasing the exemption amounts), but by then the proponents of repeal had sufficient momentum and power to reject the attempts to restrict the reach of the estate tax. In retrospect, the supporters of the transfer tax system erred in letting the estate tax exemption amount become so relatively small that the estate tax was perceived as threatening the middle class and virtually each farm and ranch in the country.

## B. ROLE OF ARTICLES ALLEGING INCOME SHIFTING POTENTIAL

As the congressional consideration of transfer tax repeal was underway, several widely discussed articles and news reports asserted that (1) significant income shifting would be possible in a transfer-tax-free environment and (2) the income shifting would generate significant revenue losses to the federal income tax.<sup>12</sup> As discussed more fully below, the articles played a significant role in the congressional consideration of transfer tax repeal.<sup>13</sup>

### 1. Background on Income Shifting

Before addressing the income-shifting techniques described in the articles, it must be conceded that certain types of income shifting have long been permitted under the Internal Revenue Code. Shifting of personal service income generally is not permitted,<sup>14</sup> and the shifting of income from property to a person, not the owner of the property, generally is not permitted.<sup>15</sup> Post-transfer income from the property and any post-transfer accrued gain do not involve income shifting because the income or gain is taxed to the person who owns the property when the income or gain accrues.

Pre-transfer accrued gain is different. Such gain theoretically should be taxed to the transferor because the transferor is the owner when the gain accrues, but shifting of such pre-transfer accrued gain long has been permitted in a gift transfer. A gift transfer generally is not a realizing event as to the donor,<sup>16</sup> and § 102 provides that receipt of the gift is income-tax-

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12. See generally Jonathan G. Blattmachr & Mitchell M. Gans, *Wealth Transfer Tax Repeal: Some Thoughts on Policy and Planning*, 90 TAX NOTES 393, 396-97 (2001), reprinted in 54 NAT'L TAX J. 569, 574-76 (2001); Buckley, *Transfer Tax Repeal Proposals*, supra note 7, at 539-40; David Cay Johnston, *Questions Raised on New Bush Plan to End Estate Tax*, N.Y. TIMES, Jan. 29, 2001, at A1. See also Attorney's Testimony at W&M Hearing on Bush Tax Relief, 2001 TAX NOTES TODAY 58-63 (2001).

13. See discussion *infra* Part II.B.2.b.

14. See generally *Lucas v. Earl*, 281 U.S. 111, 115 (1930).

15. See generally *Helvering v. Horst*, 311 U.S. 112, 115-17 (1940).

16. See *Evangelista v. Comm'r*, 629 F.2d 1218, 1221-22 (7th Cir. 1980) ("Neither [*Crane* nor *Old Colony Trust*] suggests that a gift may be a taxable disposition to the donor. No other provision of the Internal Revenue Code makes a gift taxable to the donor. While there is no section specifically excluding any value accruing to the donor in a pure gift situation, indications are that there are no income tax consequences if the transaction is a gift."); but see *Estate of Levine v. Comm'r*, 634 F.2d 12 (2d Cir. 1980) (holding that a gift of encumbered property is a realizing event to the donor under *Crane* and *Old Colony Trust* cases).

free to the donee. The § 1015 basis rules explicitly permit the shifting of the pre-transfer accrued gain by providing, for purposes of calculating gain (but not loss),<sup>17</sup> that the adjusted basis of the donee is equal to the adjusted basis of the donor immediately before the gift.<sup>18</sup> It is not uncommon to structure a gift transfer of appreciated property from a high-bracket transferor to a lower-bracket transferee with an express purpose of reducing the income tax cost of the disposition of the property. An income tax system invites such transactions if (1) the taxpaying unit is the individual, (2) rates are progressive, (3) realization, rather than accrual, is the taxable event (and a gift is not a realization event), (4) gifts are excluded from the income tax base of the donee, and (5) basis carries over from the donor to the donee.

A subsequent sale by the donee of the gift property generally would cause any resulting gain to be taxed to the donee. A subsequent sale by the donee might be attributed to the donor, however, if the sale was fully negotiated or otherwise pre-arranged by the donor.<sup>19</sup> If the sale occurred soon after the gift, special scrutiny of the transaction might be expected,<sup>20</sup> but a well-advised donor could structure a gift transaction with relatively little risk that the gain realized by the donee would be attributed to the donor for income tax purposes.

## 2. *The Alleged Income-Shifting Techniques*

The major thesis put forward in the articles is that the absence of a gift tax makes income-shifting strategies much more viable.<sup>21</sup> The articles assert that a transfer-tax-free environment would permit (1) a gift-tax-free transfer of appreciated property from a high-tax-bracket donor to a trusted related party or friend, (2) sale of the property and recognition of the gain in the property by the transferee at a net income tax cost less than if the transferor had recognized the gain, and (3) a gift-tax-free transfer back to the transferor of the net (after-tax) proceeds of sale.<sup>22</sup> In other words, the technique involves a transfer followed by a retransfer back to the original transferor. If any one of the suggested techniques

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17. The shifting of losses is restricted by § 1015. Even though § 1015 permits wholesale shifting of pre-transfer gain, different rules apply with respect to the shifting of pre-transfer loss. A special basis rule applies to the donee in the case of property the fair market value of which on the date of the gift is less than the transferor's adjusted basis immediately prior to the gift. If this loss basis rule applies, then for purposes of determining loss (not gain), the donee's adjusted basis is the fair market value as of the time of the gift. In sum, these non-mutual § 1015 rules permit pre-transfer gains to be shifted by a gift, but pre-transfer losses are subject to limitation. I.R.C. § 1015 (2002).

18. See also I.R.C. § 1015(d)(6) (2002) (providing income tax basis adjustment for portion of gift tax paid attributable to appreciation in the property).

19. See generally *Court Holding Co. v. Comm'r*, 324 U.S. 331 (1945); *United States v. Cumberland Pub. Serv. Co.*, 338 U.S. 451 (1950); *Palmer v. Comm'r*, 62 T.C. 684 (1974).

20. See *Helvering v. Clifford*, 309 U.S. 331, 335-36 (1940); *Estate of Stranahan v. Comm'r*, 472 F.2d 867, 869 (6th Cir. 1973).

21. See Blattmachr & Gans, *supra* note 12, at 574-75; Lee A. Sheppard, *Debt in Contemplation of Death*, 91 TAX NOTES 1655 (2001); Buckley, *Transfer Tax Repeal Proposals*, *supra* note 7, at 539.

22. See Blattmachr & Gans, *supra* note 12, at 396.

succeeds in shifting the income tax incidence from the transferor, significant federal income tax revenues may be lost due to the reduction in the effective tax rate applicable to the pre-transfer appreciation.<sup>23</sup>

It might seem that, in a high-wealth family likely to be able to engage in such income-shifting transfers, all parties would be in a relatively high tax bracket. In many cases, all parties would be in a high tax bracket, but that will not be true in all cases. Examples of such high-wealth but low-bracket taxpayers include (1) investors with high-growth, but low-yield investments, (2) owners of real estate improvements and other depreciable property, the deductions with respect to which are significant and protect other income from tax, and (3) persons with § 1212 capital loss carryovers.<sup>24</sup>

The absence of a gift tax also may make the transfer-retransfer scenario more likely with trusts.<sup>25</sup> Under the generally applicable statutory rules, a trust is a taxpayer for federal income tax purposes, and it must pay tax at the § 1(e) rates on its taxable income.<sup>26</sup> To the extent that a trust is a grantor trust pursuant to §§ 671-78, however, the trust is ignored, and the income, deductions, credits, etc., of the trust are reported by the person deemed to be the owner of the trust. If income shifting is desired, the settlor of the trust would not want the transferee trust to be a grantor trust pursuant to §§ 673-77 because any gain recognized by the trust would be attributed to the settlor pursuant to § 671.

Under the grantor trust provisions, the “adverse party” rules<sup>27</sup> may

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23. The absence of a federal gift tax also might facilitate the shifting of gain for state income tax purposes. The fact that some states have no income tax (or do not impose an income tax on trusts) might have significant revenue implications for states that do impose an income tax on their residents. A no-gift-tax environment would encourage taxpayers, residing in a state with an income tax, to move property to a trust with a situs in a state with no income tax on trusts. The trust would have to pay income tax to the federal government, but not to any state (because the situs state has no income tax). Only when the trust makes a distribution to a beneficiary would any state income tax be imposed. The distribution would be subject to state income tax in the hands of the distributee only to the extent of the year of distribution income of the trust, unless the state taxing the beneficiary had a throwback and/or grantor trust rules). *See generally* I.R.C. §§ 665-68 (throwback rules), 671-78 (grantor trust rules) (2002). The state tax regime also would tend to encourage the conversion of personal service income, taxed by the state of residence of the service provider, into passive income of others (one or more trusts or individuals) in a state that does not tax such income. *See Blattmachr & Gans, supra* note 12, at 398.

24. Lending some credence to the possibilities of income shifting is the fact that it has been reported that 70% of individual tax returns are taxed at or below the lowest then applicable tax bracket of 15%. *See Buckley, Transfer Tax Repeal Proposals, supra* note 7, at 539-40. Present law provides a 10% tax bracket. *See* I.R.C. § 1 (2002).

25. *See generally* Buckley, *Transfer Tax Repeal Proposals, supra* note 7, at 539-40; Blattmachr & Gans, *supra* note 12, at 396-97; Sheppard, *supra* note 21, at 1658-59.

26. *See* I.R.C. §§ 641-46 (2002).

27. An adverse party is defined by § 672(a) as follows:

For purposes of this subpart, the term “adverse party” means any person having a substantial beneficial interest in the trust which would be adversely affected by the exercise or nonexercise of the power which he possesses respecting the trust. A person having a general power of appointment over the trust property shall be deemed to have a beneficial interest in the trust.

I.R.C. § 672(a) (2002).

prevent a trust from being a grantor trust. For example, § 676 provides generally that the settlor of a trust is deemed to be the owner of the trust if, at any time, the power to revest in the settlor title to trust property is exercisable by the settlor or a non-adverse party, or both.<sup>28</sup> Thus, if only an adverse party has such a power, the trust is not a grantor trust.<sup>29</sup> The income-shifting articles maintain that the adverse party rules will have less substance if consent of the adverse party to a transfer to the settlor does not invoke a gift tax on the adverse party.<sup>30</sup>

At first glance, the income-shifting possibilities described in the articles strike me as plausible; sequential related-party transfers probably would be more widely contemplated in a no-gift-tax world. The income-shifting articles mention various non-statutory doctrines that might be used to combat the transfer-retransfer technique. Doctrines that might apply include (1) agency, (2) some type of informal trust, (3) sham, (4) step transaction, (5) substance over form, (6) business purpose, and (7) lack of economic substance.<sup>31</sup> The income-shifting articles assert, without discus-

28. See I.R.C. § 676 (2002).

29. The special treatment of an adverse party may be supported by the notion that the adverse party will not defer to the wishes of the settlor because of the adverse effect of any such consent on the economic interest of the adverse party in the trust.

30. See Richard Oshins & Jerry Kasner, *The Dynastic Trust Under the Relief Act of 2001*, 93 TAX NOTES 247, 248-50 (2001); Blattmachr & Gans, *supra* note 12, at 396-97.

31. See generally BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS, ¶ 4.3 (2002) (Pervasive Judicial Doctrines). For use of agency or constructive trust principles, see Ronald D. Aucutt, *Gift Tax Repeal Bill Minimizes Income Tax Problems*, 91 TAX NOTES 1015, 1015-16 (2001). See generally RESTATEMENT (SECOND) OF AGENCY, § 12 cmts. a-c (2002) (explaining that acts of agent on behalf of principal are considered the acts of the principal); RESTATEMENT (FIRST) OF RESTITUTION, § 160 cmts. a-i (2002) (explaining that constructive trusts are imposed when equitable).

For the sham transactions doctrine, see *United Parcel Serv. v. Comm'r*, 254 F.3d 1014, 1018 (11th Cir. 2001) (explaining the sham transaction doctrine broadly, that “[e]ven if the transaction has economic effects, it must be disregarded if it has no business purpose and its motive is tax avoidance”); *Falsetti v. Comm'r*, 85 T.C. 332, 347 (1985) (explaining the sham transactions doctrine, referred to as “sham in substance,” is the attempt “to characterize transactions contrary to objective economic realities and which have no economic significance beyond expected tax benefits”); BITTKER & LOKKEN, *supra* note 31, ¶ 4.3.4A.

For the step transaction doctrine, see *Minn. Tea Co. v. Helvering*, 302 U.S. 609, 613-14 (1938) (articulating the step transaction doctrine, that the “given result at the end of a straight path is not made a different result because reached by following a devious path” as when a complex transaction involves a party as a “mere conduit” to achieve a tax advantage); *King Entertainers, Inc. v. Comm'r*, 418 F.2d 511, 516 (Fed. Cl. 1969) (holding that the step transaction doctrine does not require that the parties are committed to a series of transactions, if such a series is contemplated); BITTKER & LOKKEN, *supra* note 31, ¶ 4.3.5; see also, *Tandy Corp. v. Comm'r*, 92 T.C. 1165, 1173 (1989) (explaining that the step transaction doctrine does not apply if the timing of individual steps “has economic substance and is motivated by valid business purposes”).

For the doctrine of substance over form, see *Gregory v. Helvering*, 293 U.S. 465, 467-68 (1935); *Grodt & McKay Realty v. Comm'r*, 77 T.C. 1221, 1236 (1981) (stating that “[i]t is well settled that the economic substance of transactions, rather than their form, governs for tax purposes”); BITTKER & LOKKEN, *supra* note 31, ¶ 4.3.3.

For the business purpose doctrine, see *Comm'r v. Transp. Trading & Terminal Corp.*, 176 F.2d 570, 572 (2d Cir. 1949) (holding that the business purpose doctrine “means that in construing words of a tax statute which describe commercial or industrial transactions we are to understand them to refer to transactions entered upon for commercial or industrial

sion or analysis, that these doctrines will not be adequate to deal with the income-shifting challenge.<sup>32</sup>

a. The Parade of Horribles

The following candidates have been offered as a potential lower-tax-rate transferee to accomplish the intended income shifting and return of the net (after tax) proceeds to the donor:<sup>33</sup>

1. Trusted relative or friend who is subject to U.S. tax.
2. Trusted relative or friend who is overseas and not subject to U.S. tax.
3. A domestic<sup>34</sup> trust that is not a grantor trust.<sup>35</sup>
4. A foreign trust of which no U.S. person is a § 679 beneficiary. Because of the reach of § 684, however, appreciated property cannot be transferred to such a foreign trust without adverse tax consequences.<sup>36</sup> The transferred amount thereafter could grow free of U.S. tax, and the beneficiary eventually could return the accumulated amount to the donor.<sup>37</sup>
5. A § 678 trust<sup>38</sup> for a trusted lower-bracket demand right powerholder; the income and gains of the trust would be taxed to the powerholder rather than the trust. The desired § 678 status could be accomplished through a demand right in favor of the trusted low-tax-bracket powerholder, even though the demand right might expire in

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purposes and not to include transactions entered upon for no other motive but to escape taxation"); Robert T. Smith, *Business Purpose: The Assault Upon the Citadel*, 53 TAX LAW. 1 (1999) (defending the business purpose and economic substance doctrines as proper and necessary exercise of judicial power); BITTKER & LOKKEN, *supra* note 31, ¶ 4.3.4.

For the lack of economic substance doctrine, see *Rose v. Comm'r*, 868 F.2d 851, 854 (holding that the "essential inquiry is whether the transaction had any practicable economic effect other than the creation of economic tax losses"). The lack of economic substance is closely related to the sham transaction doctrine. See BITTKER & LOKKEN, *supra* note 31, ¶ 4.3.4A. It is also closely related to the business purpose doctrine. See Smith, *supra*.

If the transferee has agreed to retransfer the net proceeds of sale to the transferor, the transaction may be deemed fraudulent.

32. See Buckley, *Transfer Tax Repeal Proposals*, *supra* note 7, at 540; Blattmachr & Gans, *supra* note 12, at 396-97.

33. See Blattmachr & Gans, *supra* note 12; Buckley, *Transfer Tax Repeal Proposals*, *supra* note 7; Johnston, *supra* note 12, at A1; Sheppard, *supra* note 21, at 1656; Martin A. Sullivan, *JCT Estimates Widespread Evasion with Estate Tax Repeal*, 91 TAX NOTES 10, 12 (2001).

34. Section 684 applies to certain transfers to foreign persons, including foreign trusts, to cause recognition of gain to the transferor at the time of the transfer. Section 684 is discussed more fully below.

35. The viability of the trust for income shifting is compromised by the compressed tax brackets that apply to trusts under § 1(e).

36. Section 684 provided (in 2001 during the deliberations over transfer tax repeal) that (1) any transfer of property by a U.S. person to a foreign trust is treated as a sale or exchange for an amount equal to the fair market value of the property transferred and (2) the transferor must recognize as gain the excess of (a) the fair market value of the transferred property over (b) the adjusted basis (for purposes of determining gain) of the property in the hands of the transferor. Accordingly, cash or non-appreciated property in kind would be suitable for transfer. As a result, no pre-transfer appreciation would be shifted.

37. See also Buckley, *Transfer Tax Repeal Proposals*, *supra* note 7, at 540-41.

38. See 2 U.S.C. § 639(a)(1)(B) (2002).



the future (to terminate access of the powerholder to the trust property). The trust would be a § 678 trust for so long as the demand right existed. In addition, the trust instrument could be drafted to provide, at some future date, that the trustee (or others) could add a beneficiary including the settlor. The retransfer to the transferor of the net (after-tax) sales proceeds could be made by the trust (if the demand right is never exercised and the transferor is added as a beneficiary) or by the powerholder (if the demand right is exercised).

#### b. Effect on the Legislative Process

The allegations that greater income shifting would occur in a transfer-tax-free setting had a significant impact on the participants in the reform process; the effect was to cause heartburn to some and elation to others. Three groups were effected: (1) the staff of the Joint Committee on Taxation, (2) the proponents of repeal of the transfer tax system, and (3) the opponents of repeal.

As Congress undertook consideration of transfer tax repeal in early 2001, the staff of the Joint Committee on Taxation provided a revenue estimate of the cost of repeal. During the relevant 10-year period required by congressional budget rules,<sup>39</sup> the staff of the Joint Committee estimated the revenue yield from (and the cost of repeal of) the transfer tax system at \$410 billion.<sup>40</sup> After the income-shifting articles were published (and after consultation with practitioners), the Joint Committee staff reconsidered its revenue loss estimate to factor in possible "income tax avoidance schemes."<sup>41</sup> The revised revenue loss estimate, factoring in possible income tax reductions, for the relevant 10-year period was significantly increased from \$410 billion to \$662 billion, and this did not please the proponents of repeal of the transfer tax system.<sup>42</sup> Needless to say, the revised revenue estimates provided considerable additional fodder for the opponents of repeal.

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39. See 2 U.S.C. § 601(f) (2002) (requiring the use of Joint Committee on Taxation revenue estimates by the Congressional Budget Office); Congressional Budget Act of 1974, Pub. L. No. 93-344, § 403, 88 Stat. 297, 352 (H.R. 7130).

40. See generally Sullivan, *supra* note 33, at 10.

41. See Paull's Feb. Memo to W&M Counsel on Estate and Gift Tax Estimates, 2001 TAX NOTES TODAY 60-44 (2001).

42. Stephen J. Entin, *Why the Death Tax Lives*, WALL ST. J., June 19, 2002, at A18:

In this case, JCT increased the cost of repealing the estate tax by coming up with an implausible scenario under which, after repeal, everyone would dodge their capital gains taxes. How? By parking their assets, free of gift tax, with an elderly relative who was likely to die soon, and who would then return the assets as a bequest with the advantage of a lower capital gains tax rate. (Under the current law, an heir's cost basis for capital gains purposes is the price of the asset when the benefactor died; any unrealized gains accrued before death are erased.)

What nonsense. Such revolving door transfers could have been blocked by regulations. Besides, such ploys are risky; if you give your assets to your Aunt Fanny, she may not die on schedule, or she may will the assets to your no-good cousin Fred. In short, the JCT assumed highly unlikely behavior changes that raised the apparent cost of the provision, and ignored far more certain changes in behavior that would have reduced its cost.

### III. CONGRESSIONAL ACTION

#### A. REPEAL OF THE "DEATH TAX"

The Economic Growth and Tax Relief Reconciliation Act of 2001<sup>43</sup> ("EGTRRA") made profound changes to the structure of the U.S. tax system. By way of brief review of its most significant aspects, EGTRRA, when fully implemented in 2010,<sup>44</sup> (1) repeals the estate tax, (2) repeals the generation-skipping transfer tax, and (3) repeals § 1014 step-up in adjusted basis and replaces it with a carryover basis at death regime in § 1022.<sup>45</sup>

Relatively large amounts are excluded from § 1022 carryover basis and receive a step-up to fair market value: (1) each estate can select up to \$1,300,000 of property to receive a step-up<sup>46</sup> and (2) an additional \$3,000,000 of step-up is available with respect to property transferred to a surviving spouse.<sup>47</sup> Congress anticipated that these two limited (but still generous) step-up amounts might be exploited by near-to-death transfers, and built anti-abuse rules into the statute.<sup>48</sup> Section 1022(d)(1)(C) provides that § 1022(b) (the \$1,300,000 step-up) and § 1022(c) (the \$3,000,000 step-up with respect to qualifying transfers to a surviving spouse) do not apply to property acquired by the decedent by gift or by inter vivos transfer for less than adequate and full consideration during the 3-year period ending on the date of the decedent's death. Property acquired from the decedent's spouse generally qualifies for the § 1022 step-up unless, during the 3-year period, the spouse acquired the property in whole or in part by gift or by inter vivos transfer for less than adequate and full consideration. It is noteworthy that Congress was willing to impose a three-year look back period in determining the income tax consequences to the successor in interest of the decedent.

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

44. Because of the Congressional Budget Act of 1974, EGTRRA has a sunset provision that causes the entire legislation to expire (absent intervening legislation) on December 31, 2010. See discussion *supra* note 2.

45. See generally Joseph M. Dodge, *What's Wrong With Carryover Basis Under H.R. 8*, 91 TAX NOTES 961 (2001).

46. See I.R.C. § 1022(b) (2002).

47. See I.R.C. § 1022(c) (2002).

48. See I.R.C. § 1022(d)(1)(C) (2002), which provides as follows:

**PROPERTY ACQUIRED BY DECEDENT BY GIFT WITHIN 3 YEARS OF DEATH. —**

**(i) IN GENERAL.—**

Subsections (b) and (c) shall not apply to property acquired by the decedent by gift or by inter vivos transfer for less than adequate and full consideration in money or money's worth during the 3-year period ending on the date of the decedent's death.

**(ii) EXCEPTION FOR CERTAIN GIFTS FROM SPOUSE.—**

Clause (i) shall not apply to property acquired by the decedent from the decedent's spouse unless, during such 3-year period, such spouse acquired the property in whole or in part by gift or by inter vivos transfer for less than adequate and full consideration in money or money's worth.

## B. TRANSFERS IN TRUST

Another example of the congressional unease regarding tax planning opportunities in a no-estate-tax environment is reflected by the addition in EGTRRA of § 2511(c), which applies with respect to transfers in trust made after December 29, 2009.<sup>49</sup> Section 2511(c) provides that, except as provided in regulations, a transfer in trust is treated as a transfer of property by gift, unless the trust is a grantor trust treated as wholly owned by the donor or the donor's spouse. The purpose and scope of this provision are far from clear.<sup>50</sup> Perhaps this provision reflects the sentiment that the gift tax should not apply if the transfer in trust does not accomplish an income shift, and no income shift occurs if the trust is a grantor trust. It is not clear from the language of the provision whether § 2511(c) will make any transfer in trust that otherwise would be incomplete, but is not to a trust that is such a grantor trust, a completed gift. Likewise, if the transfer is to a trust that is a grantor trust (e.g., due to the settlor retaining a § 675 administrative power) but otherwise would be a completed gift, it is not clear whether (and to what extent) the transfer is a completed gift (and, to the extent it is not a completed gift, is there a gift at the moment of death?).

## C. FOREIGN TRANSFER PROVISIONS

Section 684 was added to the Internal Revenue Code in 1997 to provide that a transfer of property to a foreign estate or trust is treated as a sale or exchange by the transferor for an amount equal to the fair market value of the transferred property.<sup>51</sup> Section 684 was amended by EGTRRA by inclusion within § 684 of any transfer (other than any "lifetime transfer")<sup>52</sup> to a nonresident alien individual. Accordingly, after the 2001 amendment (which is effective after December 31, 2009), § 684 treats as a realizing event to the transferor any transfer of property to (1) a foreign estate, (2) a foreign trust, or (3) a nonresident alien.<sup>53</sup> Section 684 prescribes recognition of any realized gain; it is silent with respect to any loss to such a transferee, but Regulations § 1.684-1(a)(2) prescribes that no loss is allowed.<sup>54</sup> Section 267 would compel such a result if the transferee were a § 267(b) related party.<sup>55</sup>

## D. GIFT TAX IS RETAINED

Even though Congress decided in EGTRRA to repeal the estate tax and the generation-skipping transfer tax, it decided to retain the gift tax.

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49. The provision was added by EGTRRA, Pub. L. No. 107-16, § 511(e), 115 Stat. 38, 71, and amended by the Job Creation and Worker Assistance Act of 2002, Pub. L. No. 107-147, § 411(g)(1). The provision applies to gifts made after December 31, 2009.

50. See generally Oshins & Kasner, *supra* note 30.

51. See I.R.C. § 684 (2002).

52. See I.R.C. § 684(b)(1) (2002).

53. See I.R.C. § 684 (2002).

54. See I.R.C. § 684 (2002).

55. See I.R.C. § 267(b) (2002).

In other words, the 2001 law effected only partial repeal of the transfer tax system. Interestingly, the Conference Committee Report is silent as to why the gift tax is retained, but (1) retention of the gift tax reduced the revenue loss associated with the legislation<sup>56</sup> and (2) the gift tax apparently was considered to be a device by which to discourage income-shifting abuses. The Joint Committee staff reportedly was prepared to offer some techniques within the income tax, rather than the gift tax, for dealing with income-shifting abuses, but the members were disinclined to deal with such new income tax anti-abuse provisions due, in part, to time pressure to complete work on the legislation by Memorial Day, as desired by the President.<sup>57</sup> Instead, the gift tax was retained.

During the phase-in of EGTRRA, the gift tax unified credit exemption equivalent amount rises to \$1,000,000.<sup>58</sup> Lifetime gifts in excess of the exemption equivalent amount (other than qualifying transfers between spouses, which will continue to be tax-free without limitation under § 2523) are discouraged because they would be subject to gift tax if made during life, even though any post-death transfer would not be subject to tax because of the absence of an estate tax.

Significantly, the gift tax rate ends up eventually (at the end of the EGTRRA phase-in period) at 35%, which is equal to the highest § 1 income tax rate.<sup>59</sup> Thus, the gift tax moves closer to being a surrogate for the income tax.<sup>60</sup> The gift-tax-as-surrogate-for-income-tax rationale is not fully accomplished, however, because (1) the gift tax applies to the entire value of the gift property, not just the gain element,<sup>61</sup> and (2) the gift transfer does not generate a basis step-up to fair market value,<sup>62</sup> which would result if the property were sold and the income tax applied to the gain. Indeed, imposing a gift tax on an income-shifting transfer is a very crude and imprecise substitute for collection of the appropriate income tax on the shifted income.

Although I do not favor repeal of the transfer tax system, it strikes me as logically inconsistent to retain a gift tax while having no estate or generation-skipping transfer tax. It is painfully obvious that the existence of a gift tax, but not an estate tax, creates no end of incentives for structuring imaginative lifetime transfers, which provide immediate economic benefit to the donee, to be deemed incomplete for gift tax purposes so that (1) the lifetime gift tax does not apply and (2) the transfer is com-

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56. See *supra* discussion of the Joint Committee revenue estimates in the text accompanying note 39.

57. See Terry L. Simmons, Giving in All Seasons: The Case for Philanthropy in Troubled Times, Speech at the Kalamazoo Community Foundation (October 9, 2002) (speech outline on file with author).

58. See I.R.C. § 2505 (2002).

59. See I.R.C. §§ 2502(a), 1(i)(2) (2002).

60. See generally Gerzog, *supra* note 7, at 983.

61. See I.R.C. §§ 2501, 2503 (2002).

62. See I.R.C. § 1015(d)(6) (2002) (basis increase according to gift tax paid on appreciation in gift property).

plete at death and, thus, not subject to any tax.<sup>63</sup> Accordingly, I am willing to consider income-shifting anti-abuse mechanisms (other than the non-statutory doctrines described above)<sup>64</sup> within the income tax, rather than the gift tax. If adequate income-tax-based mechanisms were available, I would favor repeal of the gift tax as logically congruent with repeal of the estate tax and the generation-skipping transfer tax.

#### IV. POST-EGTRRA VIABILITY OF INCOME-SHIFTING TECHNIQUES

I discuss below which, if any, of the above-described income-shifting techniques are viable after enactment of the 2001 legislation. Thereafter in Part V, I discuss whether various anti-abuse provisions within the income tax would be adequate to deal with the income-shifting problems.

##### A. TECHNICAL VIABILITY OF VARIOUS TRANSFEREES AFTER EGTRRA

I turn now to a post-EGTRRA evaluation of the income-shifting viability of the transfer-retransfer technique using various transferees identified in the income-shifting articles. With respect to each of the following transferees, I assume (without conceding on the merits) that the non-statutory doctrines are inapplicable.<sup>65</sup>

*Transfer to trusted relative or friend subject to U.S. tax with eventual retransfer to transferor.* A transfer of appreciated property to a trusted relative or friend (who is a U.S. person)<sup>66</sup> with eventual return of the after-tax proceeds of disposition to donor is subject to no specific statutory provisions and may be viable for income shifting.

*Transfer to trusted relative or friend who is overseas and not subject to U.S. tax with eventual retransfer to transferor.* A transfer of appreciated property to a trusted foreign relative or friend with eventual return of the after-tax proceeds of disposition to donor will not be successful after EGTRRA to shift the pre-transfer appreciation. The EGTRRA revisions to § 684 preclude the shift. Section 684 would treat any such transfer to a nonresident alien as a realizing event to the transferor, with the

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63. Professor Dodge has argued in favor of a "hard-to-complete rule" with respect to ambiguous lifetime transfers. Such a rule would tend to capture post inter-vivos transfer appreciation in the estate tax base and would address other value-shifting strategies to minimize transfer tax. See generally Joseph M. Dodge, *Redoing the Estate and Gift Taxes Along Easy-to-Value Lines*, 43 TAX L. REV. 241, 269-72 (1988); Dodge, *supra* note 1, text accompanying notes 133-37. In a no-estate-tax environment, perhaps the rule should be reversed and converted to an "easy-to-complete rule." See Gerzog, *supra* note 7. The answer may depend in part on whether an incomplete inter vivos gift made complete at death would be subject to the gift tax (if there is no estate tax). Gerzog asserts that a gift complete at death is unlikely to be a taxable gift (given estate tax repeal), so she argues for an easy-to-complete rule with respect to lifetime gifts. See Gerzog, *supra* note 7.

64. See *supra* text accompanying note 30.

65. *Id.*

66. This discussion is limited to transfers other than to a nonresident alien. A transfer to a nonresident alien would be subject to revised § 684; see *supra* Part III.C.

result that the pre-transfer appreciation in the transferred property would be taxed to the transferor.<sup>67</sup>

*Transfer to a domestic trust that is not a grantor trust.* If the instrument creating a domestic<sup>68</sup> trust gives an adverse party<sup>69</sup> the sole right to approve distributions to the settlor of the trust, the trust is not a grantor trust with respect to the settlor.<sup>70</sup> Accordingly, any gain recognized by the trust would not be taxed to the settlor (or taxed at the settlor's rate); instead, the gain would be taxed at the generally unfavorable tax rates<sup>71</sup> applicable to the trust (or to the trust beneficiary if the property is distributed to the beneficiary in a transaction in which gain is not recognized by the trust and the beneficiary receives a carryover basis from the trust).<sup>72</sup> Although use of a nongrantor domestic trust may succeed in shifting income, its viability to save income tax is ambiguous, at best. The trust is likely to be taxed at high rates (admittedly, the beneficiary may be taxed at lower rates), but under certain circumstances, this transferee might generate less tax, at least with respect to relatively modest amounts of income and gain.

*Transfer to foreign trust of which no U.S. person is a § 679 beneficiary.* The transfer of cash or other non-appreciated property to a foreign trust of which no U.S. person is a § 679 beneficiary has been suggested. Because the transfer involves cash or other non-appreciated property, it is designed to avoid § 684.<sup>73</sup> The transferred amounts could grow at a reduced (or zero) income tax rate, and whatever remains could be returned eventually to the transferor. This technique might well accomplish an overall income tax reduction, but this technique has long been available under U.S. tax law. This technique arguably involves no income tax abuse because it involves no income shifting as to built-in gain.<sup>74</sup> Instead,

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67. Outbound transfers long have been an enforcement problem under the Internal Revenue Code. The expanded scope of § 684 no doubt likewise will present compliance problems, but the change in the statute gives me no reason to think that noncompliance would be any worse. See Ronald D. Aucutt, *Gift Tax Repeal Bill Minimizes Income Tax Problems*, 91 TAX NOTES 1015 (2001).

68. Section 684 applies to certain transfers to foreign persons, including foreign trusts, to cause recognition of gain to the transferor at the time of the transfer. See discussion of § 684 *supra* Part III.C.

69. See *supra* text accompanying note 28 (discussing adverse party concept).

70. Accordingly, the transfer to the trust would be a completed gift, subject to gift tax under § 2511(c) (as added in 2001 to be effective after 2009).

71. The § 1 tax rates applicable to trusts progress very rapidly through the lower tax rate brackets because the dollar amounts of taxable income subject to the lower tax rate brackets are lesser amounts as compared to the other filing status amounts. This is referred to as "tax bracket compression." To the extent that the taxation of net capital gain is depends upon the tax bracket otherwise applicable to the taxpayer, the taxation of net capital gain of a trust may be less favorable than the taxation of other taxpayers with identical amounts of income.

72. See I.R.C. § 643(e) (2002).

73. See discussion of § 684, *supra* Part III.C.

74. A proper determination of the value of the property in-kind being transferred is necessary to the proper tax treatment of such a transfer. Section 684 will apply to transfers of property in-kind to the extent that the value of the property exceeds the transferor's adjusted basis.

only the post-transfer gain and/or income could be shifted and, to the extent that ownership of the underlying property is fully transferred to the transferee, it is appropriate to tax the post-transfer gain and/or income to the transferee.

*Transfer to a § 678 trust for a trusted low-bracket powerholder.* Most of the grantor trust provisions (i.e., §§ 673-77, 679) deem the settlor of the trust to be the owner of the trust. Section 678 deems a person other than the settlor as the owner of a trust with respect to which the person has sole power to vest the corpus or the income therefrom in the person.<sup>75</sup> Such a § 678 trust could be created by giving a demand right over the trust property to a powerholder. If the transferred property were to be demanded by the powerholder and then sold, the tax on the gain would be calculated by reference to the circumstances of the powerholder, not the transferor. If the transferred property were to be sold by the § 678 trust, the tax on the gain would be calculated by reference to the circumstances of the powerholder pursuant to the grantor trust rules.<sup>76</sup> Accordingly, a net reduction in tax cost might be achieved with a § 678 trust and/or the powerholder.

Of the five above-listed transferees, the first, a trusted U.S. relative or friend, appears viable for income shifting. The second transferee, a trusted foreign relative or friend, will not be effective after the 2001 EGTRRA revisions to § 684. The third transferee is a domestic trust that is not a grantor trust, and realizing an income tax savings by use of the trust is not likely to result in significant tax savings, given the § 1(e) tax rate structure. The fourth transferee is a foreign trust of which no U.S. person is a § 679 beneficiary, and this technique involves no income-shifting abuse because there can be no shift of built-in gain. The fifth transferee, a § 678 trust for a trusted low-bracket powerholder, may be viable for income shifting. To summarize, I conclude that the viable income-shifting techniques constitute a threat of unknown magnitude to the income tax (assuming the non-statutory doctrines are inapplicable).<sup>77</sup>

## B. ASSESSMENT OF INCOME SHIFTING AFTER EGTRRA

### 1. *The Rhetoric*

Some of the rhetoric used in the debate about transfer tax reform was very impassioned and at a high decibel level. Transfer taxation raises fundamental questions about the structure of society and the distributions of wealth and power, so the strong rhetoric may be expected. For example, some of the voices heard in the income-shifting articles were partisans in

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75. Section 678 also applies if (1) a person has previously partially released or otherwise modified a power to vest the corpus or the income therefrom in himself and (2) after the release or modification retains such control as would, within §§ 671 to 677, subject a grantor of a trust to treatment as the owner. See I.R.C. § 678(a)(2) (2002). In addition, § 678(a) does not apply with respect to a power over income if the grantor of the trust or a § 679 transferor is otherwise treated as the owner under the other grantor trust provisions.

76. See I.R.C. §§ 678, 671 (2002).

77. See *supra* text accompanying note 30 (non-statutory doctrines).

the legislative process,<sup>78</sup> and some of the discussion of the demise of the income tax (due to income shifting) may have been strategic and exaggerated.

## 2. *Is the Transfer-Retransfer Technique Viable?*

The proffered techniques assert that income shifting can be accomplished by the transfer of appreciated property to a trusted relative or friend with eventual return to the transferor of the after-tax proceeds of disposition. EGTRRA considered, but did not enact, provisions to deal directly with this technique.<sup>79</sup>

The transfer-retransfer scenario presents troubling issues. To the extent that the two transfers are independent, each transfer should be honored (with the result that any gain from disposition of the transferred property by the transferee would be taxed to the transferee). To the extent that the initial transfer is effective and without restriction, the transferee is the owner of the property and has interests that are adverse to the interests of the transferor. If the initial transfer and the retransfer are interrelated or the rights of the transferee are incomplete, however, the transaction may not be worthy of respect to the extent that any built-in gain should be taxed to the transferor. Deciding whether the transfers are related and complete would involve an exceedingly difficult factual determination, which would challenge both counsel for taxpayers in planning transactions and the IRS in administering the tax laws.

The income-shifting articles describe the use of a "trusted" transferee.<sup>80</sup> The implication is that this trusted transferee will not be obligated to retransfer any amount to the transferor, but the trusted transferee somehow can be relied upon to return the after-tax proceeds of sale of the property to the transferor at an appropriate time (perhaps at the request of the transferor when the transferor has sufficient "need" for the retransfer). It strikes me as a very fine line, indeed, between being "trusted" and being obliged to retransfer the property (or having an understanding to that effect). The transferor in the transfer-retransfer transaction is seeking income shifting only for income tax purposes. It strikes me as unlikely that such an aggressive taxpayer/transferor would be willing to make outright transfers of unfettered ownership without some significant assurance of getting back, in some form, the net (after-tax) proceeds of sale if the transferor is in need. It also seems likely to me that such a transferor seeking income shifting only for tax purposes is not likely to comply fully with any tax regime applicable to such transfers, whether the tax regime be in the form of the income tax (seeking to attri-

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78. See Buckley, *Transfer Tax Repeal Proposals*, *supra* note 7 (Buckley at the time was chief Democratic Tax Counsel for the House Ways and Means Committee).

79. H.R. 8, 107th Cong. (2001) contained a revision to § 7701, which would have provided additional authority to the IRS to disregard purported gift transfers if appropriate to prevent avoidance of the income tax. See discussion *infra* Part V.C.1 (proposed, but not enacted revision to § 7701).

80. See Blattmachr & Gans, *supra* note 12, at 396.



bute the gain to the transferor) or a gift tax (imposing a transfer tax). Accordingly, collection and enforcement problems are likely to be present under either an income tax or a gift tax.<sup>81</sup>

I do not address whether present law non-statutory doctrines (agency, some type of informal trust, sham, step transaction, substance over form, business purpose, and lack of economic substance)<sup>82</sup> cannot adequately police the income-shifting techniques that EGTRRA invites. It is far from clear to me that these doctrines will be inadequate to deal with the transfer-retransfer technique, but I do not undertake such an analysis in this brief comment. I do feel compelled to observe, however, that two close-in-time transfers between related persons beg for special scrutiny and might call for imposition of some of the non-statutory doctrines described above that, if applicable, would recharacterize the events so as to treat the transferor as having sold the property. Application of the non-statutory doctrines depends upon the particular facts of each situation, however, so I admit to some uncertainty as to the tax results. Accordingly, for purposes of the following discussion, I am willing to admit that this transfer-retransfer technique may be viable, and I next address income tax statutory provisions that might prevent income-shifting abuses.

## V. STATUTORY MECHANISMS WITHIN THE INCOME TAX TO DEAL WITH INCOME SHIFTING

### A. IDENTIFICATION OF THE INCOME-SHIFTING PROBLEM

Before considering what mechanisms might be effective with respect to income-shifting abuses, it is necessary to identify the income-shifting problem that needs attention. Three transactions might be considered as producing an income shift for federal income tax purposes: (1) post transfer income shifting (no built-in gain is shifted), (2) built-in gain income shifting in which the transferee realizes and reports all gain (including the built-in gain) and does not make a retransfer to the transferor, and (3)

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81. Such a transferor seeking income shifting only for income tax purposes also would raise professional responsibility problems for counsel involved in the transaction. To advise or implement such a transaction, counsel would need to be satisfied of the bona fide non-fraudulent substance of the transaction. *See generally* MODEL RULES OF PROF'L CONDUCT R. 1.2(d). I question whether counsel could advise and structure a transaction that would satisfy a transferor who wanted an income shift only for income tax purposes with no other substantial loss of ownership rights. Counsel would be challenged to provide substance to the original transfer while satisfying the expectations of the transferor-client. Counsel would need to educate the client and change the client's purpose sufficiently to give substance to the first transfer and uncertainty as to whether a retransfer would occur.

82. *See supra* text accompanying note 30 (non-statutory doctrines). *See* 2 U.S.C. § 642(a)(2). *See also* Congressional Budget Act of 1974, Pub. L. No. 93-344, § 904(c)(2), (e), 1974 U.S.C.C.A.N. (88 Stat. 297) 326, 366, *as amended by* Joint Resolution Increasing the Statutory Limit on Public Debt, Pub. L. No. 99-177, § 271(a), 99 Stat. 1037, 1094; Budget Enforcement Act of 1990, Pub. L. No. 101-508, Title XIII, § 13112(a)(11), 13208(a), 104 Stat. 1388, 1388-608, 1388-619; Line Item Veto Act, Pub. L. No. 104-130, § 4(c), 110 Stat. 1200, 1212; Balanced Budget Act of 1997, Pub. L. No. 105-33, Title X, § 10119, 111 Stat. 251, 695, *reprinted in* 2 U.S.C.A. 621 [hereinafter Congressional Budget Act of 1974, § 904].

built-in gain income shifting in which the transferee realizes and reports all gain (including the built-in gain) and does make a retransfer to the transferor.

The first-listed transaction involves no income-shifting abuse because the periodic income and gain are taxed to the owner of the property during the period such income and gain accrue. Accordingly, no income-shifting remedy is needed for this transaction.

The second-listed transaction does involve a shift of accrued gain from the transferor to the transferee, but U.S. tax law explicitly permits this transaction. Inter vivos gain shifting has been permitted in the past<sup>83</sup> and will continue after 2009 under §§ 1015 and 1022, so it seems that no remedy is needed for this transaction.<sup>84</sup>

The third-listed transaction seems to generate the most visceral negative reaction, and this transfer (with built-in gain) - retransfer transaction was the poster child for the income-shifting articles. Given the statutory rules generally permitting income shifting, it seems that only this transfer-retransfer transaction merits an anti-abuse rule. I consider below the income tax anti-abuse mechanisms that would apply to the built-in gain transfer-retransfer transaction.

## B. POLITICAL SETTING

Before addressing statutory mechanisms that might deal with this potential income-shifting problem, I want to suggest that the time is ripe to address these income-shifting mechanisms because it is likely that Congress soon will reconsider transfer taxes and related income tax matters. Policy, budget, and technical reasons all suggest that Congress will have to revisit these issues, perhaps in the near term.

On the political front, the proponents of permanent repeal were frustrated in 2001 by not being able (due to Budget Act provisions)<sup>85</sup> to make repeal of the "death tax" permanent, and they very much want to make the transfer tax system go away forever. The permanent repeal effort has a majority of votes in its favor,<sup>86</sup> but the Budget Act supermajority requirement of 60 votes in the Senate so far has precluded permanent repeal. The proponents will seek the earliest opportunity to make repeal permanent.

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83. See *supra* text accompanying notes 16-18. See 2 U.S.C. §§ 639(a), 642(a). See also Congressional Budget Act of 1974, § 904, *supra* note 82.

84. Ultimately, I conclude below that an anti-abuse rule for the transfer-retransfer transaction (the third-listed transaction above) would be unworkable. In the text following note 94, *infra*, I argue for a rate-borrowing anti-abuse provision that would apply to this second-listed transaction if the amount transferred exceeded specified exemption amounts.

85. See Johnston, *supra* note 12.

86. For the Senate majority, but not three-fifths supermajority vote, see 148 CONG. REC. S5434 (daily ed. June 12, 2002) (Roll call Vote No. 151: 54 yeas, 44 nays, 2 not voting, for a permanent repeal). For the House majority vote, see 148 CONG. REC. 1457-58 (daily ed. June 4, 2001) (Roll call Vote No. 84: yeas 274, nays 154, not voting 3, for permanent repeal) and 148 CONG. REC. H6403-04 (daily ed. Sept. 19, 2002) (Roll call Vote No. 401: yeas 242, nays 158, not voting 32, for permanent repeal).

Another factor suggesting that Congress will soon consider the transfer tax system is that permanent repeal becomes more expensive from a revenue loss standpoint as time moves forward because of the ten-year revenue loss period. In 2001, when Congress repealed the "death tax," the repeal was gradually phased in and not fully effective until 2010, and 2010 was the last year in the prescribed ten-year revenue loss period. Accordingly, much of the revenue loss associated with repeal of the "death tax" was "backloaded" and outside of the ten-year time period (the years within the ten-year period before 2010 reflected revenue losses from partial, rather than complete, repeal). If the ten-year revenue loss period remains the applicable period, it behooves the proponents of permanent repeal to do it sooner rather than later. As the relevant ten-year period moves forward in time, the revenue loss amount picks up more years of complete repeal, as opposed to the revenue loss amounts in years 2002-2009 that involve only partial repeal. In other words, the longer the proponents of permanent repeal wait, the more expensive permanent repeal will become (using the ten-year period) because the last years in the ten-year period involve total repeal rather than partial repeal. Another revenue-based reason for immediate permanent repeal is that the revenue situation facing the federal government may not be sustainable, given the large out-year revenue losses associated with EGTRRA,<sup>87</sup> to say nothing of the disappearance of the once-large projected budget surpluses<sup>88</sup> due to the weakness of the economy. If the revenue situation worsens, it will make permanent repeal more difficult to effect.

Another reason why Congress will have to address the transfer tax system relates to § 1022 carryover basis. In my opinion, carryover basis is a time bomb waiting to explode.<sup>89</sup> Compliance with it will be very difficult and immensely unpopular with the public, and executors of estates will face an uncomfortable situation in which they must consider, in making distributions of property in kind, both value and adjusted basis of the property. I expect that Congress eventually will do away with § 1022 (as it did with the carryover basis provision enacted in the Tax Reform Act of 1976 and retroactively repealed). Congress need not act immediately, however, as the effective date of § 1022 is 2010. It is clear to me that

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87. See Sullivan, *supra* note 33.

88. Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2002-2011*, available at <http://www.cbo.gov>, ch. 1 (Jan. 2001) (noting between January 2001 and January 2002 the budget surplus projections for the relevant ten-year periods decreased by \$4 trillion and that in January 2002 the budget surplus projection for 2002-2011 was approximately \$1.6 trillion); Congressional Budget Office, *Current Budget Projections*, available at <http://www.cbo.gov> (Aug. 27, 2002) (reporting the budget surplus at approximately \$1 trillion for 2003-2012); Martin Sullivan, *supra* note 33, at 1443 ("Even though the fast-shrinking 10-year budget surplus still registers at about \$1 trillion according to the latest Congressional Budget Office projections, if the Social Security surplus is excluded (as it should be), there is really a 10-year deficit of \$1.5 trillion.")

89. See Lee Sheppard, 91 TAX NOTES 1655, 1656 (2001) (stating that carryover basis is "a colossal mess. . . . Indeed, the carryover basis provisions are so awful that they cause one to appreciate that the beauty of the estate tax is that it does not concern itself with the basis of assets."). See also Dodge, *supra* note 45.

carryover basis will become ever less appealing to Congress as the effective date of § 1022 approaches.

### C. TECHNICAL SOLUTIONS

#### 1. *Dealing with Built-in Gain*

As discussed above, the sole income-shifting abuse situation seeming to merit an anti-abuse provision is the transfer-retransfer transaction, which occurs if three conditions are satisfied: (1) the transferor transfers property that has built-in gain, (2) the transferee of the property disposes of the transferred property in a taxable transaction, and (3) the transferee makes a transfer to the transferor (or anyone related to or designated by the transferor).<sup>90</sup>

As a preliminary matter, it should be noted that income shifting of built-in gain is worthwhile only if the transfer causes the income or gain to be taxed a lesser effective rate of tax than it would in the hands of the transferor. Accordingly, an effective way of combating the federal income tax revenue losses from income shifting is to negate any advantage based on the tax rates. For example, a flat-rate income tax (a politically unlikely outcome) would negate the income-shifting advantage. Similarly, any mechanism that effectively taxes the built-in gain at the tax rate applicable to the transferor, rather than the transferee, would negate the tax advantage of shifting the gain, and I discuss below several rate-borrowing mechanisms for taxing the built-in gain at the tax rate applicable to the transferor.

I now evaluate various statutory anti-abuse mechanisms to determine whether the mechanism would reach an administrable and appropriate income tax result (and, thus, would permit repeal of the gift tax). Various technical and policy choices are reflected in the following anti-abuse mechanisms: (1) does it apply only to the transfer-retransfer transaction, (2) does it require that all trigger events (e.g., the transfer, disposition, and retransfer) occur with a prescribed time period, and (3) does it require built-in gain at the time of the first transfer?

##### a. Grant Authority to IRS to Recast Transaction

H.R. 8, a transfer tax repeal bill considered in 2001, contained a proposed new § 7701(n),<sup>91</sup> which would have provided to the IRS an additional statutory anti-abuse rule. If applicable, the proposed § 7701(n)

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90. Any statutory anti-abuse rule might (1) require the transfer and retransfer to occur within a prescribed period of time and (2) exempt transactions that do not exceed an annual or lifetime exemption amount.

91. The text of the provision is as follows:

(n) PURPORTED GIFTS MAY BE DISREGARDED- For purposes of subtitle A, the Secretary may treat a transfer which purports to be a gift as having never been transferred if, in connection with such transfer—

(1)(A) the transferor (or any person related to or designated by the transferor or such person) has received anything of value in connection with such transfer from the transferee directly or indirectly, or

would have authorized the IRS to ignore the original gift transfer and deem the transferor the owner with respect to any gain resulting from the disposition of the property (by someone else). The proposed § 7701(n) would have applied if the following conditions were satisfied: (1) the transferor makes a transfer of property, (2) either (a) the transferor (or any person related to or designated by the transferor or such person) has received anything of value in connection with the transfer from the transferee directly or indirectly or (b) there exists an understanding or expectation that the transferor (or such person) will receive anything of value in connection with the transfer from the transferee directly or indirectly, and (3) the IRS determines that such treatment is appropriate to prevent avoidance of the income tax. By its terms, proposed § 7701(n) (1) would have been applicable only to the transfer-retransfer transaction, (2) did not require that the transfer and retransfer occur with a prescribed time period, and (3) did not require built-in gain at the time of the first transfer.

Enactment of this provision would have raised many immensely difficult factual questions, including (1) did the transferor (or any other identified person) receive anything of value directly or indirectly and (2) was there an understanding or expectation that the transferor (or any other identified person) would receive something of value directly or indirectly? It appears to me that there would have been considerable uncertainty as to the applicability and scope of the provision. Moreover, this provision no doubt would have caused distress to taxpayers because the IRS would have been perceived as asserting it too broadly and inappropriately,<sup>92</sup> and it would have required significant resources of the IRS to administer. Although such a statutory rule might have an *in terrorem* effect on income shifting, I doubt its viability.

#### b. Gift as Realization Event

An income shift would not occur as to the built-in gain if the initial transfer of the appreciated property were to be deemed a realization event to the transferor. Such a realization-upon-gift rule would be a big policy change, as well as a big political hurdle, and it could create a liquidity problem to the transferor, who would have to pay an income tax on the built-in gain at the time of the transfer.<sup>93</sup> Given the long-standing rule to the effect that a gift generally is not realizing event, this anti-abuse

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(B) there is an understanding or expectation that the transferor (or such person) will receive anything of value in connection with such transfer from the transferee directly or indirectly, and

(2) the Secretary determines that such treatment is appropriate to prevent avoidance of tax imposed by subtitle A.

92. See Buckley, *Transfer Tax Repeal Proposals*, *supra* note 7.

93. The liquidity problem could be ameliorated by having the transferor calculate the gain in the year of the transfer (based on the date of transfer value of the property), but report the gain and pay tax in future years, perhaps as retransfers are made. The deferred tax could be subject to an interest charge of some sort. See I.R.C. § 453A(a)(1) (2002). A deferred reporting of gain and payment of tax strikes me as having the potential for consid-

mechanism strikes me as unlikely to be implemented. The gift-as-realization mechanism (1) would not be applicable only to the transfer-retransfer transaction, (2) would not require that the transfer and retransfer occur with a prescribed period (indeed, there is no transfer-retransfer requirement) and (3) implicitly would require built-in gain at the time of the first transfer.

### c. Rate Borrowing

Another method by which to reduce the tax advantage of shifting built-in gain would be to apply the transferor's tax rate to the built-in gain. The taxable event would not be the initial transfer (as would be the case with the gift-as-realization rule discussed above); instead, the tax would be deferred until the subsequent taxable event.

Prior law § 644 (now repealed) provided such a rate-borrowing mechanism with respect to transfers of built-in gain property to a trust. Section 644 prevented any income tax rate advantage with respect to built-in gain by calculating the tax on the trust by reference to the income tax rates of the transferor, even though the gain was reported by the trust. Section 644 applied if (1) the trust (or a transferee trust) sold or exchanged the property within two years of the initial transfer in trust, (2) the property was disposed of at a gain, and (3) the fair market value of the property at the time of the initial transfer in trust exceeded the adjusted basis of the property to the trust immediately after the transfer.<sup>94</sup> If applicable, § 644 imposed a special tax on the trust with respect to the "includible gain," which was defined by § 644(b) as the lesser of: (1) the gain recognized by the trust or (2) the excess of (a) the fair market value of the property at the time of the initial transfer into trust over (b) the adjusted basis of the property immediately after the transfer. To accomplish the "borrowing" of the tax rate from the transferor with respect to the includible gain, (1) the includible gain was removed from the taxable income of the trust and the remaining taxable income of the trust was taxed at the trust's tax rate, and (2) the includible gain was taxed according to the transferor's tax rate. The tax on the includible gain was equal to the excess of (1) the income tax that would have been imposed on the transferor if the includible gain had been included in the transferor's gross income over (2) the income tax actually imposed on the transferor.<sup>95</sup> This "excess of" subtraction method of computing the tax causes the transferor's highest marginal income tax rate (not the average rate) to apply to the includible gain.

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erable complexity. To the extent that the deferral is predicated on a liquidity concern, the provision might need to coordinate the retransfer amount with the tax due.

94. Section 644(e) provided exceptions for property (1) acquired from a decedent, (2) acquired by a pooled income fund, (3) acquired by a charitable remainder annuity trust or a charitable remainder unitrust, and also (4) if the disposition occurred after the death of the transferor.

95. In addition, § 644(a)(2)(B) provided an annualization rule if the taxable years of the transferor and the trust were different.

Section 644 was restricted to property transferred to a trust, but the § 644 rate-borrowing concept could be applied more broadly. The rate-borrowing mechanism could apply to any built-in gain property transferred for less than full and adequate money's worth consideration (other than an arm's-length bad bargain).<sup>96</sup> The scope of the provision could be restricted to trusts or defined related persons such as family members, but applying the provision to any such transfer to any person (other than a charitable organization) might discourage use of a non-related person for temporary income shifting and would avoid complexities in defining related persons.

A rate-borrowing provision could exempt some small dollar transfer and retransfer amounts from its scope. The exemption amount might take the form of an annual amount and/or a cumulative lifetime amount.

To avoid over-inclusion of transactions within the rate-borrowing mechanism, its scope might be limited to apply only if all requirements for application of the provision occur within a prescribed time period. For example, § 644 required that the taxable event, the disposition of the property by the trust, occur within two years of the transfer to the trust. Congress has used other time periods that might be relevant: (1) § 1022(d)(1)(C) uses a three-year period for purposes of identifying transfers that do not qualify for step-up in basis under § 1022(b) and § 1022(c)<sup>97</sup> and (2) the § 1014(e) rule, which negates a step up with respect to near-to-death transfers, uses a one-year rule. The longer the time period, the more effective (and probably unpopular) the provision would be.

(1) *Apply rate-borrowing mechanism to transfer-retransfer transaction.* A technical problem with implementing a time period requirement with respect to the transfer-retransfer transaction is determination of the taxable event; is it (1) the taxable disposition by the transferee or (2) the retransfer to the transferor? Conceptually, the event that should invoke the rate-borrowing mechanism (which is predicated on the occurrence of each of (1) transfer of built-in gain property, (2) disposition by the transferee, and (3) retransfer) should be the last to occur of the required events. If the taxable disposition by the transferee and the retransfer occur in the same taxable year, the rate-borrowing device will work as described. If the retransfer were to occur in a taxable year before the taxable disposition by the transferee, the rate-borrowing device will work as described in the year of the disposition.

If the retransfer were to occur in a taxable year after the taxable disposition by the transferee, however, the transferee would be required to report the gain in the year of the taxable disposition without application

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96. See *Comm'r v. Wemyss*, 324 U.S. 303 (1945); Treas. Reg. § 25.2512-8. The provision also might except property (1) acquired from a decedent, (2) acquired by a pooled income fund, (3) acquired by a charitable remainder annuity trust or a charitable remainder unitrust, and also (4) if the disposition occurred after the death of the transferor. See I.R.C. § 644(e) (2002).

97. See *supra* text accompanying note 45 (discussing § 1022(b), (c)).

of the rate-borrowing mechanism. In the subsequent taxable year during which the retransfer occurs, the conditions for application of the rate-borrowing mechanism would be satisfied, but the gain would have been reported previously and taxed according to the circumstances of the transferee. To apply the rate-borrowing mechanism in this situation would require either (1) an amended return for the transferee for the year during which the gain was reported or (2) a device by which to increase the tax of the transferee for the year of the retransfer (to reflect the increase in tax that would have resulted if the rate-borrowing mechanism had applied in the prior year of the disposition). Neither option seems appealing.

Another complication associated with a rate-borrowing mechanism triggered by the transfer-retransfer transaction is that extensive reporting requirements would be necessary for enforcement of the provision. Every gift transfer of cash and property in kind by a taxpayer would have to be reported (except to the extent of any exemption provided and not with respect to a transfer to a charitable organization).<sup>98</sup>

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98. For example, H.R. 8 (2001) contained a new reporting provision, proposed § 6019, that would have required reporting by the transferor of gifts during a calendar year in excess of \$25,000, but the provision was not enacted into law. The text of the proposal is as follows:

**SEC. 6019. RETURNS RELATING TO LARGE LIFETIME GIFTS.**

(a) **IN GENERAL**—If the value of the aggregate gifts of property made by an individual to any United States person during a calendar year exceeds \$25,000, such individual shall make a return for such year setting forth—

- (1) the name and TIN of the donee,
- (2) an accurate description of such property,
- (3) the adjusted basis of such property in the hands of the donor at the time of the gift,
- (4) the donor's holding period for such property,
- (5) sufficient information to determine whether any gain on the sale of the property would be treated as ordinary income, and
- (6) such other information as the Secretary may by regulations prescribe.

(b) **EXCEPTIONS**- Subsection (a) shall not apply to—

- (1) **CASH**- Any gift of cash.
- (2) **GIFTS TO CHARITY**- Any gift to an organization described in section 501(c) and exempt from tax under section 501(a) but only if no interest in the property is held for the benefit of any person other than such an organization.
- (3) **WAIVER OF CERTAIN PENSION RIGHTS** individual waives [sic], before the death of a participant, any survivor benefit, or right to such benefit, under section 401(a)(11) or 417, subsection (a) shall not apply to such waiver.
- (4) **REPORTING ELSEWHERE**- Any gift required to be reported to the Secretary under any other provision of this title.

(c) **STATEMENTS TO BE FURNISHED TO CERTAIN PERSONS**- Every person required to make a return under subsection (a) shall furnish to each person whose name is required to be set forth in such return a written statement showing—

- (1) the name, address, and phone number of the person required to make such return, and
- (2) the information specified in subsection (a) with respect to property received by the person required to receive such statement.



(2) *Apply rate-borrowing mechanism without requiring a retransfer.* Because application of the rate-borrowing mechanism to the transfer-retransfer transaction raises complicating issues, a more restrictive rate-borrowing rule may be appropriate. Application of the rate-borrowing mechanism would be considerably simplified if it were to be applied to any transfer of built-in gain property, regardless of whether a retransfer occurs. This more restricted scope for the rate-borrowing technique would cause it to apply if (1) the transferee (or a further transferee) sold or exchanged the property within a prescribed period of time of the initial transfer and (2) the fair market value of the property at the time of the initial transfer exceeded the adjusted basis of the property to the transferee immediately after the transfer. Such a rate-borrowing device would be very similar in concept to § 644, but it would expand the scope of § 644, which applied only to a transfer in trust, to include any transfer for less than full and adequate money's worth consideration other than (1) an arm's-length bad bargain, (2) a transfer to a charitable organization, and (3) any transfer within prescribed exempt amount/s.

*Mandatory high tax rate on built-in gain.* Another relatively simple device to negate the income tax advantage of shifting built-in gain would be to tax any built-in gain recognized by the transferee within a prescribed period of time at a mandatory high rate of tax. This would avoid the computational complexities and tax-return-information sharing that § 644 required.

To summarize the foregoing anti-abuse mechanisms, the transfer-retransfer transaction is the most deserving of a special anti-abuse rule, but any mechanism tailored to the transfer-retransfer transaction would require a fairly complex statutory provision, the crafting of which would be a challenge. A less complex rate-borrowing technique would be activated if the transferee were to sell the built-in gain property at a gain within the prescribed period of time, regardless of any retransfer. This less complex solution is not ideal, as it includes within its reach not just the abusive transfer-retransfer transaction; it also would apply to any transfer of built-in gain property, regardless of whether a retransfer occurred. To ameliorate this over-inclusion, annual or lifetime exclusion amounts could remove a significant majority of transactions from the provision. Left within the scope of the no-retransfer-required rate-borrowing provision would be large dollar built-in gain transactions.

## 2. *Dealing with Trusts*

Possible mechanisms to thwart the use of trusts to accomplish income tax savings through income shifting would include (1) treating any trust as a grantor trust unless it explicitly provides that the settlor cannot at any time be a beneficiary of the trust and (2) mandatory imposition of the

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The written statement required under the preceding sentence shall be furnished on or before January 31 of the year following the calendar year for which the return under subsection (a) was required to be made.

highest possible § 1 tax rate with respect to property received within a prescribed time period of sale by the trust.

## VI. CONCLUSIONS

The logical incongruity of repealing the estate tax and the generation-skipping transfer tax, while retaining a gift tax, suggests to me the Congress should revisit the question of retaining the gift tax. If the concern of Congress with respect to complete repeal of the transfer tax system was income tax abuse, then Congress should (1) enact provisions within the income tax to deal with the abuses and (2) repeal the gift tax. The anti-abuse provisions should avoid needless complexity and should give the IRS sufficient authority and resources to prevent the income-shifting abuses. Any anti-abuse provision that is restricted to the transfer-retransfer transaction (the income-shifting abuse transaction so widely bantered about during congressional consideration of transfer tax repeal) is likely to be very complex and probably difficult for the IRS to enforce. Provisions targeted more narrowly at transfers of built-in gain property (in excess of exemption amounts), regardless of whether a retransfer occurs, would be relatively simple in operation (and administration) and may be an adequate surrogate for a more precise mechanism.

If the foregoing income tax anti-abuse mechanisms seem cumbersome (due to the technical and policy issues discussed above), perhaps an acceptable tax regime would rely on either (1) an accessions base or (2) inclusion of gratuitous transfers in the income tax base, and for these subjects I commend Professor Dodge's article for edification.

