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Families for Tax Purposes: What About the Steps?

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Wendy C. Gerzog*

At least 4.4 million families in the United States are blended ones that include stepchildren and stepparents. For tax purposes, these "steps" receive preferential treatment as a result of their status because, on the one hand, they are treated as family members for many income tax benefit sections, but on the other hand, are excluded from the definition of family member for business entity attribution purposes and for gift and estate tax anti-abuse provisions. In the interests of fairness and uniformity, steps should be treated as family members for all tax purposes where they act like their biological or adoptive counterparts, regardless of whether such treatment would decrease or increase their tax burden.

I. INTRODUCTION

At least 4.4 million families in the United States are blended ones that include stepchildren and stepparents.¹ For tax purposes, these "steps"² receive preferential treatment as a result of their status because, on the one hand, they are treated as family members for many income tax benefit sections, but on the other hand, are excluded from the definition of family member for business entity attribution purposes and for gift and estate tax anti-abuse provisions. In the interests of fairness and uniformity, steps should be treated as family members for all tax purposes where they act like their biological or adoptive counterparts, regardless of whether such treatment decreases or increases their tax burden.

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1. ROSE M. KREIDER, U.S. CENSUS BUREAU, ADOPTED CHILDREN AND STEPCHILDREN: 2000 1-2 (2003), available at <http://www.census.gov/prod/2003pubs/censr-6.pdf>.

2. As used throughout this Article, the term "step" refers to the family of a spouse who enters a marriage with children from a prior relationship. Therefore, upon marriage, a father or mother's spouse becomes a stepmother or stepfather, respectively. That father or mother or his or her biological or adopted family members will refer to their stepmother or stepfather's family members as various "steps," including stepsister, stepbrother, stepgrandparent, etc.

With a wicked stepmother and stepsisters, the fairytale of Cinderella presents only half the story.³ Undoubtedly, many steprelatives are very dear and inseparable from their biological or adopted equivalents. Today, a minimum of five percent of American households contain at least one steprelative.⁴ Reflecting this reality, family law has expanded the definition of family to include stepparents.⁵ Tax law also addresses family units,⁶ whether through income taxes that allow for dependency exemptions,⁷ corporate taxes that define attribution rules to determine family control,⁸ or wealth transfer taxes that incorporate presumptions⁹ or valuation rules dependent

3. Versions of the folktale were written by, or attributable to, among others, Charles Perrault, Mother Goose, and the Brothers Grimm. See also Daniel B. Evans, *Tax Clauses to Die For*, PROB. & PROP., July/Aug. 2006, at 38.

4. The 2000 census data recorded that about 5 percent of stepchildren under 18 lived in U.S. households, but the Census Bureau estimates that those figures account for only two-thirds of those who actually do so because the figures do not include stepchildren living in a household where the child's biological parent is not the householder. That percentage also does not include the additional almost 2 percent of stepchildren aged 18 or older who were similarly situated. Moreover, the data does not include stepchildren who have been adopted by a stepparent. Adoptions may account for a significant percentage of all stepchildren. TAVIA SIMMONS & GRACE O'NEILL, U.S. CENSUS BUREAU, HOUSEHOLDS AND FAMILIES: 2000 2-3, 6, 16, 21 (2001).

5. See, e.g., AMERICAN LAW INSTITUTE, PRINCIPLES OF THE LAW OF FAMILY DISSOLUTION: ANALYSIS AND RECOMMENDATIONS § 2.03, at 107 (2002) ("Unless otherwise specified, a *parent* is either a legal parent, a parent by estoppel, or a *de facto* parent"); *id.*, § 2.18, cmt. b., at 385-86 (defining *de facto* parents as "an allocation [of responsibility to individuals other than legal parents] that would otherwise be made to a *de facto* parent may be limited or denied if, in light of the number of other adults to be allocated responsibility, the allocation is impractical. The situation to which this provision applies will be rare, given the strict criteria defining a *de facto* parent. It may occur, however, when a child has two legal parents, a prior stepparent who is a *de facto* parent with some custodial responsibility under a prior parenting plan, and a more recent stepparent who has been providing the primary care for the child, all of whom live in separate households and seek custodial responsibility for the child.").

6. See Boris I. Bittker, *Federal Income Taxation and the Family*, 27 STAN. L. REV. 1389, 1391 (1975) ("A persistent problem in the theory of income taxation is whether natural persons should be taxed as isolated individuals, or as social beings whose family ties to other taxpayers affect their taxpaying capacity.").

7. See I.R.C. § 151(e)(3) (1954) (defining "child" as the taxpayer's "son, stepson, daughter, or stepdaughter"); *id.* § 152(a) (defining "dependent" to include the following step relations: "(2) A stepson or stepdaughter of the taxpayer, (3) A brother, sister, stepbrother, or stepsister of the taxpayer . . . (5) A stepfather or stepmother of the taxpayer"). For the purpose of calculating whether a child's parents provide over one-half of that child's support, "in the case of the remarriage of a parent, support of a child received from the parent's spouse shall be treated as received from the parent." I.R.C. § 152(c)(6) (2006).

8. See, e.g., I.R.C. §§ 318, 355, 447 (2006).

9. See, e.g., I.R.C. §§ 2701, 2702 (wherein retained rights and interests in a family transfer context are presumed to have a zero value and to constitute a gift); Treas. Reg. § 25.2703-1(b)(3) (2008) ("A right or restriction is considered to meet each of the three requirements described in paragraph (b)(1) of this section if more than 50 percent by value of the property subject to the right or restriction is owned directly or indirectly (within the meaning of section 25.2701-6) by individuals who are not members of the transferor's fam-

upon family relationships.¹⁰ There are many income tax statutes that either themselves refer to steps or reference dependency exemption definitions that include steps. These provisions¹¹ accord preferential tax treatment with respect to certain fringe,¹² education,¹³ legal,¹³ and medical¹⁴ benefits, as well as exemptions from penalties for certain early distributions to steprelatives from some

ily.”); Special Valuation Rules for Purposes of the Federal Estate and Gift Taxes, 56 Fed. Reg. 14321, 14324–14325 (Apr. 9, 1991) (explaining that, when Treas. Reg. § 25.2703-1 was proposed, “[t]his general rule does not apply to any right or restriction that: (1) Is a bona fide business arrangement; (2) is not a device to transfer the property to members of the decedent’s family for less than full and adequate consideration in money or money’s worth; and (3) is an arrangement the terms of which are comparable to similar arrangements entered into by persons in arm’s length transactions. Consistent with the legislative history, the proposed regulations clarify that these three tests are independently applied. An agreement exclusively among unrelated parties (who are not the natural objects of each others bounty) is presumed to meet these tests.”); Deduction for Claims Against the Estate, 56 Fed. Reg. 20080, 20084–20085 (proposed Apr. 23, 2007) (to be codified at 25 C.F.R. pt. 20) (“Relationships with and among a decedent and the decedent’s family members, related entities, and beneficiaries may create the potential for collusion in asserting invalid or exaggerated claims in order to reduce the decedent’s taxable estate. Thus, notwithstanding § 20.2053-1 and paragraph (a) of this section, there will be a rebuttable presumption that claims by a family member of the decedent, a related entity, or a beneficiary of the decedent’s estate or revocable trust are not legitimate and bona fide and therefore are not deductible. Evidence sufficient to rebut the presumption may include evidence that the claim arises from circumstances that would reasonably support a similar claim by unrelated persons or non-beneficiaries For purposes of this section, family members include the spouse of the decedent; the grandparents, parents, siblings, and lineal descendants of the decedent or of the decedent’s spouse; and the spouse and lineal descendants of any such grandparent, parent, and sibling. Family members include adopted individuals. For purposes of this section, a related entity is an entity in which the decedent, either directly or indirectly, had a beneficial ownership interest at the time of the decedent’s death or at any time during the three-year period ending on the decedent’s date of death. Such an entity, however, shall not include a publicly-traded entity nor shall it include a closely-held entity in which the combined beneficial interest, either direct or indirect, of the decedent and the decedent’s family members, collectively, is less than thirty percent of the beneficial ownership interests (whether voting or non-voting.”); I.R.C. § 672(c) (2006) (“For the purposes of subsection (f) and sections 674 and 675, a related or subordinate party shall be presumed to be subservient to the grantor in respect of the exercise or nonexercise of the powers conferred on him unless such party is shown not to be subservient by a preponderance of the evidence.”). Courts often state that intra-family transfers are presumed to be gifts. See *infra* note 52.

10. See, e.g., I.R.C. §§ 2032A, 2701–2704 (2006).

11. I.R.C. § 132 (2006) (exclusion for certain employee fringe benefits, such as airline tickets to airline employees and employee discounts for retail employees).

12. I.R.C. § 529 (2006) (qualified tuition programs); *id.* § 221 (deduction for interest on certain higher education loans).

13. I.R.C. § 120 (2006) (exclusion for certain benefits from qualified group legal services plans).

14. I.R.C. § 105 (2006) (exclusion for some employee benefits under certain accident and health plans); *id.* § 213 (itemized deduction for certain medical care expenses); *id.* § 220 (deduction for payments to an Archer MSA); *id.* § 223 (deduction for payments to health savings accounts); and *id.* § 402 (exclusion for certain distributions from governmental plans for health and long-term care insurance). See also I.R.C. § 214(c)(1)(A) (1954) (allowing medical deductions for the taxpayer’s dependent child or stepchild under the age 12).

retirement plans.¹⁵ Occasionally, steps are also included in the definition of “related individuals,” denying them some tax advantages,¹⁶ but this negative consequence rarely occurs; more often than not, steps are *not* treated as relatives like their biological or adopted equivalents in anti-abuse statutes¹⁷ and thus escape the negative tax consequences of being recognized as a family member.

Recently, legislators have recognized the need for uniformity in the definition of family for purposes of the Tax Code and, specifically, in the definition of a qualifying child. The move towards uniformity began in 2004 with five provisions that confer benefits on those taxpayers, including steps, who have or take care of qualifying children. Thus, the Working Families Tax Relief Act of 2004¹⁸ addressed several benefit provisions in the Tax Code that principally assist lower and moderate income taxpayers¹⁹ by providing a uniform definition of “child” to simplify dependency exemptions, head of household filing status,²⁰ the child tax credit,²¹ the depend-

15. See, e.g., I.R.C. §§ 72(t), 409A (2006).

16. See, e.g., I.R.C. §§ 21(e)(6)(A), 51(i)(1)(A), 125(e)(1)(D), 129(c), 170(g)(1) (2006).

17. See, e.g., I.R.C. §§ 163, 267, 707, 1361 (2006).

18. The Working Families Tax Relief Act of 2004, Pub. L. No. 108-311, Title II § 201, 118 Stat. 1169, § 208 (2004). These amendments apply to taxable years after 2004. See H.R. REP. NO. 108-696 (2004) (Conf. Rep.), reprinted in 2004 U.S.C.C.A.N. 1029; see also Statement by the President, 2004 U.S.C.C.A.N. S27; Tom Daley, *Unintelligent Design: The Evolution of the Uniform Definition of Child*, 111 TAX NOTES 813, 813 (2006) (“Each of the five ‘child tax sections’ offers a tax break to a taxpayer who has a connection to another person (most often a child) who meets specific qualifications.”). While this legislation has generally been praised, there are those who have criticized the uniform definition as creating more complexities as well as injecting more inequities into the Tax Code. See Susan Simmonds, *ABA Tax Section Praises Unified Definition of ‘Child’*, 105 TAX NOTES 671, 671 (2004) (“The American Bar Association Section of Taxation has given taxwriters a gold star for their development of a unified definition of child.”) But see John Buckley, *Uniform Definition of a Child: Large Unintended Consequences*, 110 TAX NOTES 1345 (2006) (describing the uniform definition as a fiasco); Daley, *supra* (finding the apparent simplicity of the uniform definition specious and describing the complexities engendered by the legislation). Cf. Nina E. Olson, *Uniform Qualifying Child Definition: Uniformity for Most Taxpayers*, 111 TAX NOTES 225, 228 (2006) (“Let’s not throw the baby out with the bathwater. In adopting a single definition of a child where five definitions existed previously, Congress provided a monumental service to approximately 160 million Americans.”).

19. Many of these benefit provisions are phased out for upper income taxpayers. See, e.g., I.R.C. §§ 24(b)(2), 34(a)(2)(B), 34(a)(b)(2), 34(a)(i), 151(d)(3) (2006). I.R.C. § 21(a)(2) (2006) provides less of a benefit for moderate income and wealthy taxpayers. There are no income limitations to file as head of household. I.R.C. § 2(b) (2006).

20. Surviving spouse filing status also refers to section 152 definitions and requires the taxpayer to maintain in her home a dependent “son, stepson, daughter, or stepdaughter.” I.R.C. § 2(a)(1)(B) (2006). However, this Code section was not part of the 2004 Act legislation. This language was used in the 1954 I.R.C. with respect to both surviving spouse and head of household status. I.R.C. § 1(b)(2)(A)(i)–2(b)(1)(B) (1954).

21. I.R.C. § 24 (2006).

ent care credit,²² and the earned income tax credit.²³ According to the legislative history of the 2004 Tax Act, the impetus for a uniform definition of a qualifying child for the purposes of these five statutes was that:

Present law contains five commonly used provisions that provide benefits to taxpayers with children Each provision has separate criteria for determining whether the taxpayer qualifies for the applicable tax benefit with respect to a particular child Thus, a taxpayer is required to apply different definitions to the same individual when determining eligibility for these provisions, and an individual who qualifies a taxpayer for one provision does not automatically qualify the taxpayer for another provision. The use of different tests . . . causes complexity for taxpayers and the IRS. The different tests relating to qualifying children are a source of errors for taxpayers both because the rules for each provision are different and because of the complexity of particular rules. The variety of rules cause taxpayers inadvertently to claim tax benefits for which they do not qualify, as well as to fail to claim tax benefits for which they do qualify. Adopting a uniform definition . . . would achieve simplification by making it easier for taxpayers to determine whether they qualify for the various tax benefits relating to children, would reduce inadvertent taxpayer errors arising from confusion due to differing rules, and would make the applicable provisions easier for the IRS to administer.²⁴

Although popular among disparate groups,²⁵ many of the supporters of this legislation came from advocacy representatives of lower income taxpayers.²⁶

22. *Id.* § 21.

23. *Id.* § 34; see also Patricia A. Cain, *Dependency, Taxes, and Alternative Families*, 5 J. OF GENDER RACE & JUST. 267, 287 (2002) ("In the past, adopted children, foster children, and stepchildren have all been excluded from tax law definitions of 'child.' That omission has been generally remedied.")

24. S. REP. NO. 108-257, at 85 (2004); see also Staff of the Joint Comm. on Tax'n, *Simplification of the Internal Revenue Code*, reprinted in 91 TAX NOTES 999 (2001).

25. See Robert F. Manning, *Cuttings on the Conference Floor: Will the Crafts Take?*, 100 TAX NOTES 217, 228 (2003) ("The JCT, the National Taxpayer Advocate, the Treasury, the ABA Section of Taxation, the AICPA, TEI, and other professional groups have commented on the current complexity and recommended a uniform definition of qualifying child."); *Simplification of the Internal Revenue Code*, supra note 24, at 1002-1003 ("This recommendation would provide simplification for substantial numbers of taxpayers.")

26. See David Lupi Sher, *The Tax Bill—Congress Attempts to Overhaul EITC to Make It Taxpayer-Friendly*, 91 TAX NOTES 1661, 1663 (2001) ("Diana Leyden, a University of Connecticut

In contrast, Congress has not pushed corporate and transfer tax provisions towards uniformity. This lag is most likely due to the fact that maintaining the status quo serves the self-interest of many wealthy taxpayers and voters. In these tax areas, extending uniformity to corporate control and wealth transfers (i.e., to the highest income taxpayers and to those with the most wealth and power) will not bring those taxpayers many benefits²⁷ and indeed may result in negative tax consequences. Nonetheless, this Article will argue that such an extension of uniformity should occur for the following reasons: first, complete uniformity in the definition of “child” is preferable to a piecemeal, “pick and choose” tax policy; and second, such a change would more accurately reflect the actual relationship between those steprelatives who share their wealth and power.

Moreover, such an extension of uniformity is in line with subtle changes in the Code reflecting the high rate of divorce and remarriage prevalent today.²⁸ The 1986 generation skipping transfer tax,²⁹

School of Law professor and a director of a low-income tax clinic . . . [stated] ‘The failure to adopt a uniform definition of qualifying child will mean that those taxpayers who are least able to handle complex tax laws may continue to be painted with a broad brush as cheats’’); *Simplification of the Tax System: Hearing Before the Subcomm. on Oversight of the H. Comm. on Ways & Means*, 108th Congress 13 (2004) (statement of Elizabeth Maresca, Associate Clinical Professor, Fordham University School of Law) (“It is my privilege to testify before you and to urge you to adopt this much needed tax simplification proposal which will replace the current multiple definitions of a qualifying child with a single, sensible Uniform Definition of a Qualifying Child. This change will benefit both low income taxpayers and the IRS, as it makes our tax system more fair and efficient.”). See also Gene Steuerle, *How Complexity Arises for Low-Income Taxpayers*, 92 TAX NOTES 561, 562 (2001) (“The Joint Committee on Taxation’s recent recommendation to create a common definition of qualifying child for many provisions affecting households with children is a solid one that is long overdue.”). This recommendation continues to resonate with low-income taxpayer advocates. See Testimony of David Marzahl, Executive Director of the Center for Economic Progress, *Issues, Challenges, and Opportunities: Low-Income Taxpayers and the Tax Code* 8 (“Disparate treatment of children within tax code creates unnecessary confusion and errors—new rules for ‘uniform definition of qualifying child’ may help.”); ADAM CARASSO, JEFFREY ROHALY, & C. EUGENE STEUERLE, URBAN INST., *A UNIFIED CHILDREN’S TAX CREDIT* 1 (2005) (“This effort [the proposal for a unified children’s tax credit] follows on the heels of a number of proposals to consolidate and strengthen tax programs that benefit low-income families and reflects the spirit of the more uniform tax definition of a qualifying child that was enacted by the Working Families Tax Relief Act of 2004.”).

27. There are the benefits of I.R.C. § 2032A (2006) and I.R.C. § 6166 (2006), for example.

28. See ARTHUR J. NORTON & LOUISA F. MILLER, U.S. CENSUS BUREAU, *MARRIAGE, DIVORCE, AND REMARRIAGE IN THE 1990’S* 5 (1992) (“High divorce rates create, among other things, a large pool of eligibles for remarriage. Remarriage in the United States has become a relatively common life course event. Currently more than 4 out of 10 marriages in the United States involve a second or higher-order marriage for the bride, the groom, or both.”).

29. I.R.C. § 2601 (2006).

the 1986 provision taxing unearned income of a minor,³⁰ and, to some extent, the valuation rules applicable to post-1990 gifts³¹ provide illustrations of how, at least with respect to more recently enacted legislation, Congress has recognized that steprelatives are, in many instances, akin to blood or adopted relatives. The 1996 enactment of qualified tuition plans³² provides the broadest coverage of steps: by incorporating the definition of a “qualifying relative” from the dependency exemption definitions³³ for the designation of a member of the old beneficiary’s family,³⁴ this section encompasses such wide ranging steps as stepchildren, stepgrandchildren, stepsiblings, and stepparents.³⁵

While the income tax provisions have provided many tax benefits to steps, the extension of a uniform application of the definition of steprelative to include parallel steps³⁶ in the corporate and transfer tax areas will generally be disadvantageous to steps. There may, however, be some additional consequential benefits to wealthy steps if state inheritance taxes follow the example of the federal regime, which they often do. Some states already have inheritance tax statutes that treat stepchildren the same as natural or adopted children, often providing steps the benefit of exemptions from those taxes or subjecting them to the lower rate enjoyed by natural and adopted children.³⁷ For example, Maryland treats stepchildren (current and

30. I.R.C. § 1(g) (2006).

31. I.R.C. §§ 2701–2704 (2006).

32. I.R.C. § 529 (2006) (qualified tuition plans) was enacted by the Small Business Job Protection Act of 1996, Pub. L. No. 104-188, Title I, § 1806(a), 110 Stat. 1895 (1996).

33. I.R.C. § 152(d)(2)(A)–(G) (2006). Under this provision, not only are steps included as family members, but certain in-laws are included as well. See I.R.C. § 152(d)(2)(G) (2006).

34. I.R.C. § 529(e)(2) (2006) (“(A) the spouse of such beneficiary; (B) an individual who bears a relationship to such beneficiary which is described in subparagraphs (A) through (G) of section 152 (d)(2); the spouse of any individual described in subparagraph (B); and (D) any first cousin of such beneficiary.”).

35. I.R.C. § 529(e)(2)(B) (2006). Of course, the definition also includes their spouses as well as any first cousin of the old beneficiary. I.R.C. § 529(e)(2)(C)–(D) (2006).

36. By parallel steps, I mean step versions, just like adopted persons, who are treated like the blood related family members listed in the Tax Code definitions. I also think that a wider range of relatives, like those found in section 152, makes sense to describe a uniform definition of the taxpayer’s family for all purposes. See *infra* Part IV.

37. IND. CODE § 6-4.1-1-3(a) (2006) (“‘Class A transferee’ means a transferee who is a: . . . (3) stepchild of the transferor, whether or not the stepchild is adopted by the transferor; [or] (4) lineal descendant of a stepchild of the transferor, whether or not the stepchild is adopted by the transferor.”); IOWA CODE § 450.9 (2005) (stepchildren are exempt from tax on the net estate); KY. REV. STAT. ANN. § 140.070(1) (West 2008) (Class A beneficiaries include “stepchild,” which like decedent’s child is subject to a lower tax rate); MICH. COMP. LAWS § 205.202 (2003) (a stepchild or a lineal descendant of a stepchild is treated as a child or a lineal descendant of a child to exempt the first \$50,000 given to him from taxation); N.J. STAT. ANN. 54:34-2.1 (West 2009) (“The transfer of property passing to a stepchild of decedent . . . shall be taxed at the same rates and with the same exemptions as the transfer

former) and children equally, to the effect that neither is subject to the state inheritance tax.³⁸ Since many states are influenced by federal tax treatment, a uniform Federal approach to taxing steps may increase the odds that states will do likewise.³⁹

In addition, uniform tax treatment that addresses wealth transfers may cause some states to change their intestacy laws, which presumptively reflect their residents' collective attitudes⁴⁰ to include steps somewhere in their schemes.⁴¹ Currently, the few

of property passing to a child of said decedent born in lawful wedlock."); 72 PA. CONS. STAT. § 9116(1.2) (2008) (there is no inheritance tax from a child decedent twenty years old or younger to either his parent or his stepparent); S.D. CODIFIED LAWS § 10-40-23(3) (2004) (exemption from inheritance tax for \$30k passing to decedent's stepchild or lineal issue or any lineal descendant of his stepchild); TENN. CODE ANN. § 67-8-302 (2008) (Class A beneficiaries include decedent's stepchild, like his lineal descendants, for the purposes of the state's inheritance tax).

38. MD. CODE ANN., TAX-GEN. § 7-203(b)(1)(ii) (West 2008) (effective for those decedents dying on or after July 1, 2000) ("Child" includes a stepchild or former stepchild."). Although property transfers from the decedent to the lineal descendants (or their spouses) of a stepchild are exempt from Maryland inheritance taxes, such a transfer to a lineal ascendant of that stepchild is taxed at 10%. See ALLAN J. GIBBER, GIBBER ON ESTATE ADMINISTRATION § 5.6, at 5-4.2 (4th ed. 2005 & Supp. 2005) ("TG § 7-203(b)(1) raises the question of whether a grandparent or a grandchild would include a step relationship. On its face, the statute appears not to include such relationship. TG § 7-203(b)(2)(i) refers to a 'grandparent.' TG § 7-203(b)(2)(iv) and (v) refer to 'a lineal descendant of a child.' The impact of this is to exempt from inheritance tax a bequest from a grandparent to a child of a stepchild, (i.e., a lineal descendant of a child, including a stepchild), but to subject to tax a bequest from that same child of a stepchild to the grandparent. Also subject to tax is a bequest from a grandparent to a stepchild of a child, who fails to qualify as a 'lineal descendant' of the child."). Moreover, a transfer to a stepsibling would not qualify for the Maryland inheritance tax exemption. *Id.* § 5.5. ("Property passing to a stepbrother is subject to tax at 10%; property passing to a half brother is exempt.").

39. Otherwise, "[i]n some states the stepchildren would bear a larger share of state wealth transfer tax burden if state law imposes a higher rate on stepchildren than it does on natural born or adopted children." Jeffrey N. Pennell, *Tax Payment Provisions and Equitable Apportionment*, SM093 A.L.I.-A.B.A. 1097 (2007); see also Sol Lovas, *When Is a Family Not a Family? Inheritance and the Taxation of Inheritance within the Nontraditional Family*, 24 IDAHO L. REV. 353, 385 (1987-88) ("Unless the statute specifically provides a preferred classification for stepchildren, they are deemed strangers to the blood and are subject to the higher inheritance tax rates.").

40. Intestacy triggers a state's default provisions. They are intended to reflect what most decedents would want to happen to their property had they specified themselves in a proper will. See Martin L. Fried, *The Uniform Probate Code: Intestate Succession and Related Matters*, 55 ALBANY L. REV. 927, 928-929 (1992). Alternatively, they may be used as instruments of social policy. See Kristine S. Knaplund, *Grandparents Raising Grandchildren and the Implications for Inheritance*, 48 ARIZ. L. REV. 1, 8 (2006) (comparing the 1969 UPC with the 1990 UPC and stating "[w]hether intestacy law is really intended to carry out the average decedent's intent, rather than to carry out public policy goals, is the subject of some debate.").

41. Most articles on this issue urge such inclusion. See, e.g., Susan N. Gary, *Adapting Intestacy Laws to Changing Families*, 18 LAW & INEQ. 1, 15-16 (2000); Margaret M. Mahoney, *Stepfamilies in the Law of Intestate Succession and Wills*, 22 U.C. DAVIS L. REV. 917 (1989); Andrew L. Noble, *Intestate Succession for Stepchildren in Pennsylvania: A Proposal for Reform*, 64 U. PITT. L. REV. 835 (2003); Thomas M. Hanson, Note, *Intestate Succession for Stepchildren: California Leads the Way, But Has It Gone Far Enough?*, 47 HASTINGS L.J. 257 (1995).

states⁴² that do include steprelatives in their intestacy laws often do so right before the decedent's property would otherwise escheat to the state⁴³ and often *after* "laughing heirs" are allowed to take.⁴⁴ The current position of most intestacy laws is to assume a decedent would prefer her property to devolve to a distant blood or adopted relative rather than to "the devil (or the step) she knows."

This Article will explore the Tax Code and its rules that accord steprelatives tax benefits both by inclusion in the definition of family member or by exclusion from the definition of family member for business entity attribution purposes or gift and estate tax anti-abuse provisions. These inconsistencies in the treatment of steprelatives have not yet been fully investigated despite their long-standing existence and easily identifiable status. Ironically, while there are articles attempting to grapple with what constitutes a family member for tax purposes in a nontraditional family relationship, there is a lack of literature that attempts consistently to define, for tax purposes, when a step is a family member, which should be an easier exercise.⁴⁵

42. Currently, only Connecticut, Maryland, Ohio, and South Carolina provide for stepchildren. See Noble *supra* note 41, at 836 ("In fact several states [Alaska, Florida, Hawaii, and Idaho] expressly exclude stepchildren from their plan of intestate distribution.")

43. See, e.g. MD. CODE ANN., EST. & TRUSTS § 3-104(e) (West 2008) ("If there is no surviving blood relative entitled to inherit under this section, it shall be divided into as many equal shares as there are stepchildren of the decedent who survive the decedent and stepchildren of the decedent who did not survive the decedent but of whom issue did survive the decedent."). With respect to these stepchildren, each receives one share in the pattern of representation. *Id.* § 1-210. However, "[a]s used in this subsection, 'stepchild' shall mean the child of any spouse of the decedent if such spouse was not divorced from the decedent." *Id.* § 3-104(e).

44. See, e.g. MD. CODE ANN., EST. & TRUSTS § 3-104(d) (West 2008) ("If there is no surviving parent or issue of a parent, or surviving grandparent or issue of a grandparent, it shall be distributed one quarter to each pair of great-grandparents equally or all to the survivor, or if neither survives, all to the issue of either or of both of that pair of great-grandparents by representation. In the event that neither member of a pair of great-grandparents nor any issue of either of that pair survives, the quarter share applicable shall be distributed equally among the remaining pairs of great-grandparents or the survivor of a pair or issue of either of a pair of great-grandparents, in the same manner as prescribed for a quarter share.") Can you name each of your great-grandparents? How about each of their issue? That's why they are called "laughing heirs"—at decedent's death, they are laughing all the way to the bank. For a discussion of the source of this term, see JESSE DUKEMINIER, STANLEY M. JOHANSON, JAMES LINDGREN, & ROBERT H. SITKOFF, *WILLS, TRUSTS, AND ESTATES* 81–82 (7th ed. 2005).

45. The existing literature, for the most part, focuses either on steps and intestacy, see *supra* note 41, on steps and other non-tax aspects of law, see, e.g., Mary Ann Mason, *The Ambiguous Stepparent: Federal Legislation in Search of a Model*, 29 *FAM. L.Q.* 445 (1995); Margaret M. Mahoney, *Stepfamilies in the Federal Law*, 48 *U. PITT. L. REV.* 491 (1987); Margaret M. Mahoney, *Support and Custody Aspects of the Stepparent-Child Relationship*, 70 *CORNELL L. REV.* 38 (1984), or on newer, or at least more recently discussed, types of relationships such as civil unions or gay and lesbian relationships, see, e.g., Cain *supra* note 23; Patricia A. Cain, *Federal Tax Consequences of Civil Unions*, 30 *CAP. U. L. REV.* 387 (2002); Lovas, *supra* note 39. *But see*

This Article argues that steps should be treated uniformly throughout the Tax Code. Part Two will discuss the tax consequences of voluntary action by steprelatives. Part Three addresses the treatment of transfers that occur during the marriage of a step. Part Four analyzes the benefits and disadvantages conferred on steps by income Tax Code provisions. Part Five discusses steps in the context of family attribution rules for corporations and partnerships while Part Six analyzes wealth transfer taxes. Part Seven then concludes by proposing a framework for the uniform treatment of steps.

II. STATUS V. VOLUNTARY ACTION

The status of being a steprelative tells us virtually nothing about the substantive familial relationship between two individuals. We all know of steprelationships that are, for all practical purposes, either non-existent or antagonistic as well as those that are harmonious and loving. On the other hand, there are natural or adoptive family relationships that cover that same gamut. Nonetheless, the status of being a step currently does not, for the most part,⁴⁶ alter tax consequences and the presumption is that marrying someone with children does not by itself create a parent/child relationship between the steprelatives.⁴⁷ For example, in a situation where a

Bridget J. Crawford, *The Profits & Penalties of Kinship: Conflicting Meanings of Family in Estate Tax*, 3 PITT. TAX REV. 1 (2005) (reviewing three estate tax sections (I.R.C. §§ 2036, 2032A, and 6166) and proposing that they apply to “the full range of associational relationships that function in fact as ‘families.’”). Professor Crawford concludes, however, that “a uniform definition would make the law easier to apply, but it would result in systematic over-taxation and under-taxation. Instead the statutes should be revised to use unique terms that apply for limited purposes.” *Id.* at 3–4. Steps are one of the family relationships she considers in the article.

46. When the taxpayer claims a step as a dependent by filing a joint tax return with her spouse, that fact may or may not indicate that taxpayer's contribution of support for her step. That is, the child's biological or adoptive parent may qualify for the dependency exemption in his own right. See I.R.C. §§ 151, 152 (2006). Thus, it is primarily the status of being a spouse but also indistinguishably or simultaneously the status of being a stepparent that changes the stepparent's tax consequences.

47. Generally, no assumption is made for tax purposes merely because of the status of being a step. That is currently the tax treatment of a parent's liability for his or her child's taxes: while the allocation of a child's deficiency is generally a joint one for both spouses, unless a stepchild is legally adopted by the parent's spouse, a stepchild's liability is not allocated to the non-parent spouse, but remains the sole liability of the parent spouse. See Treas. Reg. § 1.6015-3(d)(4)(iii) (1953). I.R.C. § 6013(h)(1) (2006) provides for the promulgation of regulations on methods of allocating liability. However, a stepparent may benefit from that status by being able to share the dependency deduction with his spouse who may actually provide the full support for her child, but the benefit more directly results from his being able to file a joint return with her and his status of being her spouse.

stepparent voluntarily gives or bequeaths property to her stepchild, she is acting like a family member and that relationship should require the stepparent and stepchild to be taxed like their biological or adoptive equivalent. Nonetheless, the tax code does not recognize this change in the familial relationship and continues to exclude steprelatives from the definition of family member. Fairness and uniformity dictate that the Tax Code recognize that such transfers evidence an incorporation of the steprelative into the family.

The potential for abuse provides another rationale for requiring that the Tax Code treat steprelatives as family members. In *DeBoer v. Commissioner*,⁴⁸ when a taxpayer sold a two family apartment house to his stepgrandson, he and his wife, the transferee's grandmother, filed a joint income tax return and claimed a deduction for the loss incurred in the sale. The tax court held that the predecessor statute to the current loss disallowance section⁴⁹ did not disallow that loss despite the fact that, as the government had contended, "by the use of the joint return [his wife was] benefiting from a deduction which, under the terms of the Code is expressly denied her"⁵⁰ The court, however, rejected that argument. As underscored by *DeBoer*, because of the abuse potential, during the step's marriage to the parent of a biological or adopted child, the step should be considered a family member for loss disallowance purposes.⁵¹ Likewise, if during the stepparent's marriage to the stepchild's parent, the stepchild sells property to her stepparent at a loss, but at the current fair market value, the loss to the stepchild should be disallowed because of the abuse potential. If the marriage terminates, however, and the same transaction occurs, the loss should be allowed because, after the divorce, there is no longer a bright line familial relationship. Lastly, because of the greater abuse potential, transfers made from parents to stepchildren should also be reviewed with the same strict scrutiny that is applied to transfers from parents to biological and adopted children.⁵²

48. *DeBoer v. Comm'r*, 16 T.C. 662 (1951), *aff'd per curiam* 194 F.2d 289 (2d Cir. 1952).

49. I.R.C. § 24(b) (1939). The current related taxpayer loss disallowance section is I.R.C. § 267 (2006).

50. *DeBoer*, *supra* note 48, at 664. This was a court reviewed opinion of the Tax Court and, in dicta, the court stated "[a] different issue would be presented if [his wife] had owned a part of the property in question." *Id.* (dictum).

51. If two septuagenarians marry and the step sells property to his stepgrandchild at a loss, where he files a separate return from the natural parent, I.R.C. § 267 (2006) should not apply to him.

52. *See, e.g.*, *Kimbell v. United States*, 371 F.3d 257, 265 (5th Cir. 2004) (noting although transfers between family members should be subject to heightened scrutiny, such scrutiny should be limited to the examination of objective facts); *Estate of Constanza v. Comm'r*, 320

To illustrate the issue further, consider the following scenario: mom and stepdad own stock in a corporation and, during their marriage, mom gratuitously transfers her stock to her biological daughter. For tax purposes, should the daughter's shares be aggregated with her stepfather's during his marriage to her mother? The stepdaughter's shares should be combined with her stepfather's for two reasons. First, the transfer is indicative of a true familial relationship; and second, it would be too easy for the mother and stepfather to avoid aggregation in this manner, since before the transfer, mom's shares would have been combined with her husband's. Nonetheless, if the mother's marriage to the stepfather ends in divorce, aggregation based on the natural parent's transfer of stock during that marriage should cease at its dissolution as the family bond has been severed and the abuse concern lessened.

Where a stepparent accepts or has accepted the tax benefits of the "step" relative status, she should not be able to deny it in other tax contexts. For example, under the current Tax Code, steprelatives, due to their status, receive tax advantages through gift-splitting,⁵³ for gift tax purposes as an increased annual gift tax exclusion,⁵⁴ lower marginal gift tax rates,⁵⁵ use of both spouses'

F.3d 595, 597 (6th Cir. 2003) ("[A] SCIN signed by family members is presumed to be a gift and not a bona fide transaction."); *Harwood v. Comm'r*, 82 T.C. 239, 258 (1984) ("Transactions within a family group are subject to special scrutiny, and the presumption is that a transfer between family members is a gift."), *aff'd*, 786 F.2d 1174 (9th Cir. 1986) (unpublished table opinion); *Kincaid v. United States*, 682 F.2d 1220, 1225 (5th Cir. 1982) ("The problem here, however, is that we deal entirely with an intra-family transfer, a circumstance which has always prompted special scrutiny by the courts precisely because the genuineness of the transaction cannot reasonably be inferred from any circumstantial assurances of a business purpose."); *Estate of Labombarde v. Comm'r*, 58 T.C. 745, 755 (1972); *Estate of Trenchard v. Comm'r*, T.C. Mem. 1995-121 (Mar. 22, 1995).

53. 26 C.F.R. § 25.2513(a)(1) provides:

A gift made by one spouse to any person other than his spouse shall, for the purposes of this chapter, be considered as made one-half by him and one-half by his spouse, but only if at the time of the gift each spouse is a citizen or resident of the United States. This paragraph shall not apply with respect to a gift by a spouse of an interest in property if he creates in his spouse a general power of appointment, as defined in section 2514(c), over such interest. For purposes of this section, an individual shall be considered as the spouse of another individual only if he is married to such individual at the time of the gift and does not remarry during the remainder of the calendar year.

26 C.F.R. § 25.2513(a)(1) (2006). You must file a gift tax return to split gifts with your spouse. See C.F.R. §§ 25.2513(b), 25.2513-1(c), 25.2513-2.

54. I.R.C. § 2503 allows a taxpayer to make a tax-free gift in the amount of the annual exclusion of a present interest in property to unlimited donees. I.R.C. § 2503 (2006). For 2009, that amount is \$13,000 per donee per year. Internal Revenue Service, *Frequently Asked Questions on Gift Taxes*, <http://www.irs.gov/businesses/small/article/0,,id=108139,00.html#3> (last visited June 13, 2009) (on file with the University of Michigan Journal of Law Reform).

unified credits,⁵⁶ and their generation-skipping transfer tax exemptions.⁵⁷ In these contexts, to promote uniformity, the Code should treat steps as family members and equivalent to natural and adopted relatives. As it currently stands, the gift-splitting provision allows stepparents indirectly to transfer property to stepchildren. That is, absent statutorily defined gift-splitting, to secure twice the annual exclusion amount or the combined lower marginal gift tax rates, a spouse who wants to transfer property to his child would need first to transfer part of the property to his wife who would then transfer it to her stepchild.⁵⁸ Indeed, gift-splitting parallels the tax treatment of gifts made by married couples in community property states. To qualify for gift-splitting, the non-propertied spouse must sign her consent to the application of the gift-splitting provisions.⁵⁹ This voluntary action, which has significant legal consequences,⁶⁰ should trigger the equal treatment of steps and their natural or adopted relations.⁶¹

Equity, uniformity, and abuse potential are the main reasons to tax steps as family members like their biological and adopted counterparts. A stepparent who treats his stepchild like his own child by making gifts to her connects with her as a family member and should, in all fairness, be taxed as a related individual. Moreover, when a stepparent is married to the stepchild's parent, not treating the stepparent as a relative creates too much tax

55. The gift tax rates range from 18% to 45% in 2007. I.R.C. § 2001(c)(1)-(2)(B) (2006). When gifts are split between spouses, the marginal rate applied to one-half of the gift is often lower than that applied to the total.

56. I.R.C. § 2505 provides for a unified credit against the gift tax imposed under § 2501 in the amount of a maximum of \$1,000,000 per U.S. citizen or resident. I.R.C. § 2505 (2006).

57. I.R.C. § 2631 provides for an exemption from the generation skipping transfer tax imposed by § 2601 in an amount equal to that year's applicable exclusion amount. I.R.C. § 2631 (2006). For 2007 and 2008, that amount is \$2,000,000 for each individual. I.R.C. § 2010(c) (West 2008).

58. For less liquid assets, this two-part transfer would likely involve some practical difficulties and added costs.

59. I.R.C. § 2513(a)(2) (2006).

60. A consequence of gift-splitting is the joint and several liability for all gift taxes imposed on each spouse for that consent year. I.R.C. § 2513(d) (2006). Further, although for estate tax purposes, the donor is the spouse who actually made the gift, for gift tax purposes, the stepspouse is considered the donor of one-half of the property. I.R.C. § 2502 (2006). That is, to the extent that the split gift used the non-donor spouse's unified credit for gift taxes and her gift tax rates, those benefits are lost to her. *Id.*

61. Gift-splitting may be contrasted with filing a joint income tax return with the child's parent. *See supra* notes 46-47. Although the benefits accrue to the donor who is the child's biological relation and to the steprelative who is the recipient of the gift, the decision to split a gift with one's spouse more closely parallels the consenting spouse's making an indirect gift to her step than filing a joint income tax return with a spouse that may be done for a variety of tax saving reasons besides sharing in a dependency exemption deduction.

avoidance potential. Finally, where some tax provisions enumerate steps as family members, mostly for the purposes of securing tax benefits, steps should be included in the definition of family for all tax purposes to achieve uniformity.

III. ONCE A STEP, ALWAYS A STEP?

As described above, transfers from a step to a steprelative (e.g., from stepdaughter to stepmother) during the spouse's marriage are sufficiently voluntary to consider those steprelatives as family members for all Tax Code purposes. If that marriage ceases, however, should it trigger a re-classification of the relationship? The answer should be: not necessarily.

For tax purposes, the bond established between steps by voluntary wealth transfers should not be presumed to be broken when a stepparent dies or divorces the stepchild's biological parent with respect to any gratuitous transfers the stepparent has made⁶² or continues to make to the stepchild. For example, if a stepparent has given property to her stepchild and, after her divorce from the stepchild's father, the stepchild sells that same property back to his stepmother at a loss, the loss should be disallowed under the related party loss disallowance section because the step should be considered part of the family with respect to this particular gift;⁶³ moreover, if the stepparent later sells the same property to a third party at a gain, the same statute should reduce her gain by the loss previously disallowed to the stepchild.⁶⁴ However, those post-death or post-divorce consequences should apply only to the specific property gratuitously transferred to the step. After a divorce, the stepmother (if she can still be called such) should be able to sell other property to her stepson at a loss and she should be able to recognize a loss. That is, that loss disallowance section for transfers between related parties should not apply to the other property's sale.

62. That includes a gift by way of gift-splitting.

63. I.R.C. § 267(a) (2006).

64. I.R.C. § 267(d) (2006). That is, suppose the stepmother gives her stepson property with a basis to her of \$10,000 and FMV of \$20,000. After the stepmother divorces her husband, the stepson sells that property back to his stepmother at its current FMV of \$5,000. Under I.R.C. § 267(a), that loss (\$10,000 [the stepson's carryover basis] minus \$5,000 [his amount realized], resulting in a loss of \$5,000) should be disallowed. When she later sells the property for \$30,000, rather than having a \$25,000 gain, her gain should be reduced, under I.R.C. § 267(d) by the previously disallowed loss to her stepson so that she should have a \$20,000 gain. I.R.C. § 267(a), (d) (2006).

Furthermore, where a tax consequence that begins before the divorce has post-divorce effects, the step should continue to be treated as a family member. Specifically, if during the mother's marriage the stepfather's loss on a sale of property to his stepchild has been disallowed by statute, the ameliorative tax consequences of that statute on a later sale at a gain should continue to apply even after the mother and stepfather divorce. Thus, after the couple's divorce, if his stepdaughter sells that same property to an unrelated third party at a gain, the related party loss disallowance section should continue to classify the stepdaughter as family so that her recognized gain at the later sale is diminished to the extent of the earlier loss disallowed to her stepfather. Moreover, where current Code sections specifically treat ex-spouses as family members, such as GSTT generation assignments, the step should continue to be considered a family member after the marriage ends.⁶⁵

In contrast, where family attribution rules attach to steprelatives in order to prevent tax avoidance,⁶⁶ steps should not be treated as family members upon the divorce or death of the natural parent. In this context, the steprelative has not taken any voluntary action evidencing a familial relationship and has not necessarily acted as a family member. For example, if a biological father gave fifty shares of stock to his son and if the stepmother who is married to the biological father also gave one share to her stepson, during the couple's marriage all fifty-one shares of stock would be attributable, as applicable, either to the father or to the stepmother. If the marriage ceases, however, only the one share the stepmother actually gave to her stepson should be attributed to her and only the fifty shares the biological father gave to his son should be attributed to him. This example illustrates the difference between a voluntary transfer and a situation of abuse potential. Where the marriage ends, only the voluntary transfer continues to have tax consequences for the step because, with a divorce, the abuse potential between ex-spouses is substantially reduced. This result follows from the different rationale for treating steps as family members in gift, rather than abuse potential situations.

65. I.R.C. § 2651 deals with GSTT generation assignments. See I.R.C. § 2651 (2006); see also I.R.C. § 1361(c)(1)(B) (2006) (including former spouses of lineal descendants).

66. See *supra* Part I; see also I.R.C. § 318 (2006) (defining family members to determine the constructive ownership of stock).

IV. INDIVIDUAL INCOME TAXES

The Code's income tax provisions similarly treat steps inconsistently. A number of income Tax Code provisions, including the five provisions in the 2004 Tax Act⁶⁷ and those income tax provisions that provide for a multitude of additional benefits, including medical benefits to stepchildren,⁶⁸ treat stepchildren no differently from biological or adopted children. Steps, however, are generally not included in the definition of family member where such treatment would create adverse tax consequences for the step taxpayer. For example, steprelatives are not considered family members under the related party loss disallowance statute.⁶⁹ That omission has widespread consequences as that Code section is referenced as the standard definition of family member in many other anti-abuse provisions.⁷⁰

Occasionally, the Code includes steps in the definition of "related individuals," denying them some tax advantages.⁷¹ This negative consequence, however, seldom occurs; more often than not, steps are *not* treated as related individuals, thereby escaping the policy objectives of anti-abuse provisions.⁷²

A. *Income Tax Benefits to Steps*

In 2004, Congress enacted legislation to provide for a uniform definition of the term "qualifying child" that would be applicable to five income tax sections providing benefits to taxpayers with "dependent" children.⁷³ Section 152(f)(1)(A)(i) defines a child as "a son, daughter, stepson, or stepdaughter of the taxpayer."⁷⁴ A "qualifying child" is any child, including the taxpayer's stepbrother

67. See *supra* notes 18–26 and accompanying text.

68. See *infra* Part IV.A.

69. I.R.C. § 267(a) (2006). I.R.C. § 267(b)(1) (2006) describes persons and entities related to the taxpayer as including "members of a family, as defined in subsection (c)(4)." I.R.C. § 267(c)(4) (2006) provides that the "family of an individual shall include only his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants." That identical definition of family appeared in I.R.C. § 267 under the 1954 Code.

70. See *infra* note 121.

71. See, e.g., I.R.C. §§ 21(e)(6)(A), 51(i)(1)(A), 125(e)(1)(D), 129(c), 170(g)(1) (2006). Moreover, steps are denied a deduction for adoption expenses when the step is adopting her spouse's child. See I.R.C. § 23(d)(1)(C) (2006).

72. See *infra* Part IV.B.

73. I.R.C. §§ 151–152 (2006).

74. I.R.C. § 152(f)(1)(A)(i) (2006); Treas. Reg. § 1.152-3(a) (2008). The definition of a child also includes an "eligible foster child of the taxpayer." I.R.C. § 152(f)(1)(A)(ii) (2006).

or stepsister “or a descendant of any such relatives.”⁷⁵ A dependent child is a qualifying child⁷⁶ or a qualifying relative⁷⁷ and a qualifying relative includes the taxpayer’s stepbrother or stepsister⁷⁸ as well as her stepfather or stepmother.⁷⁹ Under these uniform definitions, steps are included in the head of household definition,⁸⁰ the dependent care credit,⁸¹ the child tax credit,⁸² the earned income tax credit,⁸³ and the personal exemption a taxpayer may take for her dependents.

In addition, the Tax Code extends additional benefits to steps. For example, for “no-additional-cost” fringe benefits, such as free available airline travel or hotel rooms for employees, or “qualified employee discounts,” such as the perks offered to department store employees, the term “employee” is defined broadly to include dependent stepsons or stepdaughters.⁸⁴ Thus, when an airline employee receives free tickets to Rome for herself and her stepchild or when the Best Buy employee allows his stepchild to purchase a large screen television using his employee discount, the employee does not have to pay any income tax on that additional compensation.

Certain education tax benefits, such as education savings bonds⁸⁵ and qualified tuition plans,⁸⁶ are also available to steprelatives. When income from education savings bonds is used to pay higher education expenses, it is excludible from the taxpayer’s income.⁸⁷ Those higher education expenses include tuition and fees of the taxpayer’s dependents for whom she is allowed a dependency exemption deduction.⁸⁸ Because it incorporates the dependency exemption definitions,⁸⁹ this educational benefit applies to steps to the same extent that it applies to blood or adopted relatives.

75. I.R.C. § 152(c)(2)(B) (2006) (defining a “qualifying child”).

76. I.R.C. § 152(a)(1) (2006).

77. I.R.C. § 152(a)(2) (2006). “Qualifying relative” is defined in I.R.C. § 152(d) (2006).

78. I.R.C. § 152(d)(2)(B) (2006).

79. I.R.C. § 152(d)(2)(D) (2006).

80. I.R.C. § 2(b)(1)(A)(i) (2006).

81. I.R.C. § 21(b)(1)(A) (2006).

82. I.R.C. § 24(c)(1) (2006).

83. I.R.C. § 32(c)(3)(A) (2006).

84. I.R.C. § 132(h)(2)(B) (2006) (referring to the definition of “child” in I.R.C. § 152(f)(1) (2006)); Treas. Reg. §§ 1.132-1(b)(5), 1.132-1T(b)(4) (2008).

85. I.R.C. § 135 (2006). This section was added by the Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, Title VI, § 6009(a), 102 Stat. 3688 (1988).

86. I.R.C. § 529 (2006).

87. I.R.C. § 135(a) (2006).

88. I.R.C. § 135(c)(2)(A)(iii) (2006).

89. I.R.C. § 151(c) (2006).

In addition, Congress enacted the qualified tuition plan statute both to provide an incentive for college savings and to clarify the tax consequences of State pre-paid tuition programs and it clearly applies to a wide variety of steprelations.⁹⁰ In general, neither the contributor nor the designated beneficiary of a qualified tuition program has taxable income as long as earnings are used to pay qualified higher education expenses.⁹¹ The definition of family member in this provision includes, among other relatives,⁹² the relationships in the dependency exemption definitions describing a “qualifying relative.”⁹³ Thus, this tax benefit is available to a stepchild or stepchild’s descendants, stepsibling, or stepparent (or any of their spouses).

In 2001, Congress substantially expanded⁹⁴ the definition of family member to include the first cousins of the beneficiary, widening the family circle beyond any other Code provision defining family membership.⁹⁵ Moreover, if a qualified tuition program has excess funds in an account or if the contributor wishes to change the designated beneficiary, she may benefit many types of steps without triggering any adverse tax consequences.⁹⁶ That is, substituting a new beneficiary will not constitute a distribution, otherwise includible in income and subject to a ten percent penalty, so long as “the new beneficiary is a member of the old beneficiary’s family” and that list contains a wide-ranging group of steps.⁹⁷

90. S. REP. NO. 104-281, at 160 (1996), *reprinted in* 1996 U.S.C.C.A.N. 1474, 1580 (“The Committee believes that it is appropriate to clarify the tax treatment of State-sponsored prepaid tuition and educational savings programs in order to encourage persons to save to meet post-secondary educational expenses.”).

91. I.R.C. § 529(c)(1)(A)–(B) (2006).

92. The statute also includes the beneficiary’s spouse, the spouse of any of the individuals listed in I.R.C. § 152(d)(2) (2006), and any of the beneficiary’s first cousins. I.R.C. § 529(e)(2)(A), (C)–(D) (2006).

93. *See supra* notes 77–79 and accompanying text.

94. The Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, § 402(a)(1)–(4)(A), (C), (D), (b)(1), (c)–(g), 115 Stat. 60–63 (sunset of termination on December 31, 2010). The 2001 Act expanded the definition of a qualified tuition program (QTP), provided for a maximum room and board allowance for QTPs, expanded the definition of “member of the family” to include first cousins of the original beneficiary, provided for the exclusion of distributions that are applied to qualified higher education expenses, and imposed an additional 10 percent tax on taxable distributions. H.R. REP. NO. 107-84, at 79–81 (2001), *reprinted in* 2001 U.S.C.C.A.N. 46, 154–156. In addition, the legislation clarified that no deduction was available for money attributable to excludible earnings although a deduction was allowable for funds not so matched. *Id.* at 168.

95. I am excluding such concepts as “objects of the bounty” found in I.R.C. § 2703 since that term is defined in addition to family members for the application of that section. *See infra* notes 199–206 and accompanying text.

96. I.R.C. § 529(c)(2)(C)(ii) (2006).

97. I.R.C. § 529(c)(3)(C)(ii), (e)(2)(B) (2006).

On the other hand, neither a child nor a stepchild may deduct the interest on education loans if another taxpayer can claim the stepchild as a dependent on his tax return since this provision likewise refers to the dependency exemption criteria to define "dependent."⁹⁸

In another example of including steprelatives in the definition of family member, steps may receive the many medical and health tax benefits offered to their biological and adoptive counterparts. First, the medical expense deduction is available for uncompensated medical costs paid by the taxpayer for her dependents as that term is used in the dependency exemption definitions,⁹⁹ and amounts paid for medical care for (or for the permanent loss of a body part or function of or disfigurement) the taxpayer's dependent as defined in that Code section may be excluded from the taxpayer's income.¹⁰⁰ That "dependent" definition statute is also the pivotal provision for steps' coverage in Archer MSA's,¹⁰¹ health savings accounts,¹⁰² and for distributions from government plans for health and long-term care insurance.¹⁰³

Finally, steprelatives also benefit from other miscellaneous tax provisions that reference the dependency exemption definitions to classify the taxpayer's dependents including the exclusion for employer provided group legal services¹⁰⁴ and the exemption from the ten percent penalty for early distributions from a qualified plan made to unemployed individuals to the extent that they are used to pay health insurance costs for the taxpayer, her spouse, or her dependents.¹⁰⁵ Likewise, when amounts are distributed early from a nonqualified plan due to an "unforeseeable emergency" relating to the participant, his spouse or his dependent (using the dependency exemption definitions like in the case of distributions to their

98. I.R.C. § 221(c), (d)(4) (2006).

99. I.R.C. § 213(a) (2006).

100. I.R.C. § 105(b), (c)(1) (2006).

101. I.R.C. § 220(d)(2)(A) (2006). An Archer MSA is a medical savings account where you can provide for your future medical costs. According to the IRS, the benefits of such an account include 1) a deduction for non-itemizers, 2) tax-free interest and growth of your assets in the account, 3) tax-free distributions if paying "qualified medical expenses," 4) contributions that roll over into the next year if unused, and 5) portability. See INTERNAL REVENUE SERVICE, PUBLICATION 969, HEALTH SAVINGS ACCOUNTS AND OTHER TAX-FAVORED HEALTH PLANS 8 (2006), available at <http://www.irs.gov/pub/irs-pdf/p969.pdf>.

102. I.R.C. § 223(d)(2)(A) (2006). This section references I.R.C. § 213 (2006) as well. See *supra* note 14.

103. I.R.C. § 402(l)(1) (2006).

104. I.R.C. § 120(a), (d)(4) (2006).

105. I.R.C. § 72(t)(2)(D)(i)(III) (2006).

blood and adopted dependents) steps are exempt from gross income inclusion.¹⁰⁶

B. Anti-abuse Income Tax Provisions and Steps

Anti-abuse provisions governing transactions between family members are necessary to prevent taxpayers from undermining the purposes of the tax laws. Congress allows a taxpayer who sells investment real estate at a loss, for example, to recognize the economic loss in that transaction through a tax deduction.¹⁰⁷ Sales between “family members,” however, present opportunities for taxpayers to manipulate the timing of a loss, so that when a taxpayer sells property at a loss to a family member, Congress denies that deduction.¹⁰⁸ There are a few anti-abuse provisions that equate steps with biological relatives, but they are the exception. In most instances, steps are not covered by these statutes.¹⁰⁹ The anti-abuse individual income tax provisions that treat steps as biological or adopted equivalents are generally very narrow subsections. For example, in the Code section for cafeteria plans, in the subsection that denies an income tax exclusion for highly compensated participants where the plan discriminates in their favor, or to benefit their spouse or dependent, their dependents are referenced to the dependency exemption definitions.¹¹⁰ Likewise, the exclusion for dependent care assistance programs disallow the exclusion where the employee pays a related individual, as defined under that section,¹¹¹ for such childcare.¹¹² Finally, such a limited application of the dependency exemption definitions occurs once in the myriad of subsections of the charitable deduction section where a taxpayer may take a deduction for the costs of maintaining only non-dependent taxpayer-related students in her household¹¹³ and simi-

106. I.R.C. § 409A (2006).

107. I.R.C. § 165(c)(2) (2006).

108. I.R.C. § 267 (2006).

109. However, steps and their biological or adopted counterparts are both denied the qualified tuition and related expense deduction under I.R.C. § 222(c)(3) (2006) where they can be claimed as dependents by another taxpayer under I.R.C. § 151 (2006). The same is true for the deduction for health savings accounts under I.R.C. § 223(b)(6) (2006).

110. I.R.C. § 125(e)(1)(D) (2006); *see also id.* § 21(e)(6)(A) (2006); *id.* § 51(i)(1)(A) (2006); *id.* § 129(c) (2006); *id.* § 170(g)(1) (2006). Each of these statutes reference I.R.C. § 152 (2006). I.R.C. § 21(e)(6)(A) (2006) references I.R.C. § 151(c) (2006) and that, in turn, references the definitions in I.R.C. § 152 (2006).

111. I.R.C. § 152(f)(1) (2006).

112. I.R.C. § 129(c)(2) (2006).

113. I.R.C. § 170(g)(3) (2006) (defining the term as “relationships described in subparagraphs (A) through (G) of section 152(d)(2)”). On the other hand, I.R.C.

larly restricts the work opportunity credit for payments to such related persons.¹¹⁴

On the negative tax consequence side, however, the 1986 enactment of a provision taxing the unearned income of a minor at her parents' tax bracket when it is higher than the child's own rate, envisioned including both parents and stepparents in those calculations.¹¹⁵ The legislative history of this section, which was enacted to prevent income shifting from wealthy parents to their lower tax bracket children, uses the terms parent and stepparent as equivalents¹¹⁶ and the temporary regulations indicate that purpose as well.¹¹⁷

§ 170(f)(10)(H) prohibits a deduction where there is an understanding that the organization would provide a personal benefit such as life insurance or an annuity contract to the transferor or his family; that family is defined without reference to section 152 and does not include steps. I.R.C. § 170(f)(10)(H) (2006) ("For purposes of this paragraph, an individual's family consists of the individual's grandparents, the grandparents of such individual's spouse, the lineal descendants of such grandparents, and any spouse of such a lineal descendant.").

114. I.R.C. § 51(i)(1)(A) (2006) (referring, likewise, to "relationships described in subparagraphs (A) through (G) of section 152(d)(2)").

115. Tax Reform Act of 1986, Pub.L. 99-514 § 1411(a), 100 Stat. 2085 (1986) (enacting § 1(i), effective for taxable years after 1986 (§ 1411(c))); *see also* H.R. REP. NO. 99-841 (1986) (Conf. Rep.), *reprinted in* 1986 U.S.C.C.A.N. 4075, 4855-4857. The Omnibus Reconciliation Act of 1990, Pub.L. 101-508, § 11101(d)(2), 104 Stat. 1388, re-designated subsec. (i) as (g) for taxable years after 1990 and the Tax Increase Prevention and Reconciliation Act of 2005, Pub.L. 109-222, § 510(a), (c), 104 Stat. 1990 (2006), extended the application of this section to unearned income of a minor under the age of 18 instead of under the age of 14. There are special rules for determining the parent for purposes of this section—if the parents are unmarried, the parent is the custodial parent as determined by section 152(e) and, if they are married, but filing separate returns, the parent is the one with the greater taxable income. I.R.C. § 1(g)(5)(A)-(B) (2006). Parents may elect to include their child's unearned income in their own return. I.R.C. § 1(g)(7) (2006).

116. H.R. REP. NO. 99-841 (1986) (Conf. Rep.), *reprinted in* 1986 U.S.C.C.A.N. 4075, 4855 ("The top rate of the parents is deemed to be the top rate applicable to individuals unless the parent assigns an unused rate bracket amount at a lower rate to the child. Earned income and unearned income derived from assets received from sources other than a parent that are placed in a qualified segregated account are taxed at the child's rate. *Property eligible to be placed in a qualified segregated account includes earned income, money, or property received from someone other than the parent or step-parent, and property received by reason of the parent's or step-parent's death.*") (emphasis added). The Senate amendment was basically the same as the House Bill. *Id.* ("The Senate amendment generally is the same as the House bill, except that the tax payable by a child on the parental source unearned income is equal to the additional amount of tax that the parent would be required to pay if the child's parental source unearned income were included in the parent's taxable income The conference agreement follows the Senate amendment except that the provision is applied to all net unearned income of a child under 14 years of age regardless of the source of the assets creating the child's net unearned income.")

117. *See* Treas. Reg. § 1.1(i)-1T (Q. & A. 13-14) (1987) ("Answer 13: The amount of a parent's taxable income that a child must take into account for purposes of section 1(i) where the parent files a joint return with a spouse who is not a parent of the child is the total taxable income shown on such joint return Question 14: In determining a child's share of the allocable parental tax, is the net unearned income of legally adopted children,

Only rarely does equal treatment of steprelatives with biological relatives result in adverse tax consequences. There are virtually no adverse corporate, partnership, or estate and gift tax consequences because steps are not considered family members for those provisions. That is because the related persons loss disallowance section¹¹⁸ that defines the taxpayer's family to "include only his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants" is in effect.¹¹⁹ In so doing, this anti-abuse provision is inapplicable to steps. First, that statute itself denies a deduction for losses between related persons, including members of the taxpayer's family,¹²⁰ but does not include steps. Second, and even more significant, that Code section is referenced in well over sixty other Code provisions,¹²¹ many of which deal with

children related to such child by half-blood, or children from a prior marriage of the spouse of such child's parent taken into account in addition to the natural children of such child's parent? Answer 14: Yes. In determining a child's share of the allocable parental tax, the net unearned income of all children subject to tax under 1(i) and who use the same parent's taxable income as such child to determine their tax liability under section 1(i) must be taken into account. Such children are taken into account regardless of whether they . . . are children from a prior marriage of the spouse of such child's parent.").

118. I.R.C. § 267(a)(1) (2006) defines a deduction for "any loss from the sale or exchange of property, directly or indirectly, between persons specified in any of the paragraphs of subsection (b)."

119. I.R.C. § 267(c)(4) (2006) (family members are defined in this section for the purposes of applying the constructive ownership of stock under section (b)). I.R.C. 267(g) (2006), however, provides that the loss disallowance section shall not apply to any transfer between spouses or ex-spouses incident to a divorce that are covered under section 1041, which itself disallows not only losses, but also gains between such persons.

120. I.R.C. § 267(b)(1) (2006).

121. References to section 267 related parties and to 267(c)(4) family members abound and are found in such Code sections as I.R.C. §§ 42(d)(2)(D)(iii); 45D(f)(2)(B); 50; 56(e)(3)(B)(ii); 101(j)(2)(B)(i), (3)(B)(ii)(I); 108(e)(4)(B); 121(d)(8)(B); 144(a)(3)(A); 147(a)(2)(A); 162(n)(3); 163(e)(3)(C)(ii), (j)(4), (l)(6), (n)(4); 165(l)(2)(D); 167(e)(5)(B), (g)(5)(C); 168(k)(2)(E)(iv)(I), (3)(C)(ii)(II); 170(a)(3), (e)(5)(C)(ii); 179(d)(2)(A); 179A(b)(2)(B); 197(f)(9)(C)(i)(I)-(II); 213(d)(11)(B); 221(d)(1)(C); 263A(h)(3)(D)(i)(I); 274(e)(4); 280A(d)(2)(A); 280F; 304(b)(5)(A)(i)(II); 318; 336(d)(1)(A); 351(g)(3)(B); 355(d)(7)(A), (g)(2)(B)(ii)(III); 382; 409(n)(3)(A)(ii); 447(h)(1)(B)(ii)(I), (h)(2)(A); 453(f)(1)(B); 464(c)(2)(E); 465(b)(3)(C); 468B(d)(3); 469(g)(1)(B); 483(e)(2); 503(b)(6); 512(b)(1)(J)(i); 514(c)(9)(B)(iii); 613A(c)(8)(D)(ii), (d)(1)(E); 631(c)(1); 643(i)(2)(B)(i) (note that section 643(i)(2)(B)(i) incorporates spouses in addition to family members as defined in section 267(c)(4), stating "[i]n applying section 267 for purposes of the preceding sentence, section 267(c)(4) shall be applied as if the family of an individual includes the spouses of the members of the family."); 664(g)(5)(A)(i); 679(a)(3)(C) (by referencing 643(i)(2)(B)(i)); 685(c)(2)(A); 707(b)(1)(B); 755(c)(1); 871(h)(4)(B); 877(g)(2)(A)(i); 904(h)(3)(B); 936(h)(3)(D)(i)(I), (ii); 988(c)(1)(E)(I); 1031(f)(3); 1033(i)(3); 1060(e)(3); 1202(c)(3)(A), (j)(2)(C); 1235(d); 1237(a)(2)(A); 1239(c)(1)(C), (c)(2); 1259(c)(4)(A); 1397(a)(2)(B); 1400B(e)(5); 1400C(e)(2)(A)(i); 4946(a)(3)-(a)(4); 4951(e)(4)(H); 4975(e)(4)-(5) (however, under § 4975(e)(6), for the purposes of paragraph (2)(F), family includes "spouse, ancestor, lineal descendant, and any spouse of a lineal descendant."); 4951(f)(6)(A)(iii), (B)(ii); 4985(a)(2); 5881(c)(2); 6038A(c)(2)(B); 6166(b)(2)(D), (g)(1)(D); and 6664(d)(3)(B)(ii)(I) (2006).

family attribution rules to determine constructive ownership for corporate and partnership anti-abuse objectives. There are very few sections that, by referencing that loss disallowance statute, restrict *benefits* to steps, but they include a provision that denies steps a larger exclusion for certain life insurance proceeds.¹²²

Similarly, the anti-abuse grantor trust rules,¹²³ which tax the grantor as the owner of trust income when she transfers property but retains certain ownership interests or control,¹²⁴ include only the following members in the grantor's family: her "father, mother, issue, brother or sister"¹²⁵ in the definition of a "related or subordinate party." That restricted definition, inapplicable to steps, limits some of the anti-abuse grantor trust consequences.¹²⁶

V. FAMILY ATTRIBUTION RULES FOR CORPORATIONS AND PARTNERSHIPS

Like many income tax anti-abuse provisions, corporate and partnership family attribution rules refer to definitions of family that do not include steps. While the mere status of being a step should not

122. The general rule, with respect to certain employer-owned life insurance contracts, is to exclude from gross income not more than the total premium or other amounts expended by the policy owner for the insurance contract. However, the reduced exclusion has an exception for amounts paid to, among certain other beneficiaries, the insured's family as defined under section 267(c)(4). See I.R.C. § 101(j)(2)(B)(i) (2006).

123. I.R.C. §§ 671-678 (2006). The grantor trust rules were enacted in their present form in the 1954 Code. Pub. L. 591, 83rd Cong., 2nd Sess., 68 Stat. 3, 226 (Supp. A 1954). Parts of the grantor trust rules were enacted earlier, with the earliest enacted as part of the Revenue Act of 1924, Pub. L. 68-176, ch. 234, § 219(g) (1924). This statute is the predecessor statute to the current I.R.C. § 676 (2006), which treats the grantor as the owner, for income tax purposes, of his revocable trust. However, the statutory form of sections 671-678 first appeared in the 1954 legislation.

124. S. REP. NO. 1622, at 86-87 (1954), *reprinted in 2 INTERNAL REVENUE ACTS OF THE UNITED STATES: THE REVENUE ACT OF 1954 WITH LEGISLATIVE HISTORIES AND CONGRESSIONAL DOCUMENTS 86-87* (Bernard D. Reams Jr. ed., 1982) ("[T]he rules for determining when the grantor should be treated as the substantial owner of the trust should be set forth in the statute rather than left to regulations . . . Under the regulations, the grantor will be taxed on the trust income if certain related or subordinate trustees hold such a power. Under the bill, the grantor will not be taxed if he can establish that the related or subordinate trustee is not acting in accordance with the grantor's wishes. However, the grantor must overcome a presumption that the related or subordinate party is subservient to him."). See *Schulz v. Comm'r*, 686 F.2d 490, 495 (7th Cir. 1982) ("The main thrust of the grantor trust provisions is that the trust will be ignored and the grantor treated as the appropriate taxpayer whenever the grantor has substantially unfettered powers of disposition. The hallmark of such discretion is that the grantor can act unilaterally or with the concurrence of someone who is not an 'adverse party.'").

125. I.R.C. § 672(c)(2) (2006).

126. Because steps are not family members, I.R.C. §§ 674(c) and 675(3) (2006), which refer to grantor's relatives, are not applicable to steps.

make a step a family member, the transfer of stock or other entity ownership interests, directly or indirectly, between a taxpayer and a step should cause steps to be classified as their biological or adopted equivalents for all tax purposes, including entity attribution and wealth transfer rules. However, because of the impact of the application of the related party loss disallowance section and the lack of steps in its definition of family members,¹²⁷ there are many corporate and partnership anti-abuse provisions that do not apply to steps.¹²⁸

Specifically, a partnership tax section,¹²⁹ which itself cites to the relationships in the related party loss disallowance statute and which is also referenced in other Code sections,¹³⁰ deals with sales or exchanges between a partner and a partnership; where a partnership constitutes a controlled partnership, certain loss deductions are disallowed and gains from those sales or exchanges are treated as ordinary income.¹³¹ Control is defined as more than a fifty percent ownership of the capital interest or the profits interest¹³² and those interests are determined by applying “the rules for constructive ownership of stock provided in section 267(c)”¹³³

127. See *supra* Part IV.B.

128. See *supra* note 121.

129. I.R.C. § 707 (2006).

130. See, e.g., I.R.C. §§ 42(d)(2)(D)(iii); 45D(f)(2)(B); 101(j)(3)(B)(ii)(I); 108(e)(4)(B); 121(d)(8)(B); 144(a)(3)(A); 147(a)(2)(A); 163(j)(4), (1)(6); 168(k)(2)(E)(iv)(I); 170(a)(3); 179(d)(2)(A); 179A(b)(2)(B); 197(f)(9)(C)(i)(I)–(II); 221(d)(1)(C); 304(b)(5)(A)(i)(II); 351(g)(3)(B); 355(d)(7)(A); 465(b)(3)(C); 469(g)(1)(B); 512(b)(19)(J)(i); 514(c)(9)(B)(iii); 613A(c)(8)(D)(ii); 631(c)(1); 643(i)(2)(B)(i); 685(c)(2)(A); 871(h)(4)(B); 877(g)(2)(A)(i); 936(h)(3)(D)(i)(I), (ii); 988(c)(1)(E)(I); 1033(i)(3); 1060(e)(3); 1202(c)(3)(A), (j)(2)(C); 1235(d); 1259(c)(4)(A); 1397(a)(2)(B); 1400B(e)(5); 1400C(e)(2)(A)(i); 5881(c)(2); 6038A(c)(2)(B); 6664(d)(3)(B)(ii)(I) (2006).

131. I.R.C. § 707(b)(1)–(2) (2006).

132. For example, I.R.C. § 707(b)(1) provides for the disallowance of:

losses from sales or exchanges of property (other than an interest in the partnership), directly or indirectly, between—(A) a partnership and a person owning, directly or indirectly, more than 50 percent of the capital interest, or the profits interest, in such partnership, or (B) two partnerships in which the same persons own, directly or indirectly, more than 50 percent of the capital interests or profits interests. In the case of a subsequent sale or exchange by a transferee described in this paragraph, section 267(d) shall be applicable as if the loss were disallowed under section 267(a)(1). For purposes of section 267(a)(2), partnerships described in subparagraph (B) of this paragraph shall be treated as persons specified in section 267(b).

I.R.C. § 707(b)(1) (2006). I.R.C. § 707(b)(2) (2006) reads similarly with respect to recognized gains.

133. I.R.C. § 707(b)(3) (2006). The 1954 Code version of this section had the same reference to section 267 family attribution rules to determine the ownership of a capital or profits interest in a partnership to match the construction stock ownership rules. Pub. L. 591, 83rd Cong., 2nd Sess., 68 Stat. 3, 244 (Supp. A 1954).

Because steps are not included in these partnership attribution rules, this Code section, as well as other anti-abuse provisions referencing that partnership tax section's definition, is inapplicable to steps. However, because those sections generally reflect voluntary actions, such as a sale or exchange, they clearly should apply to steps to the same extent they pertain to the blood or adopted relatives listed under the related party loss disallowance section.

Similarly, for constructive ownership of corporate stock under a corporate tax provision,¹³⁴ an individual's family members are "his children, grandchildren, and parents"¹³⁵ and only adopted children are considered "a child by blood."¹³⁶ Yet, that Code section, together with several other Code sections that incorporate its definition of family,¹³⁷ do not extend to steps, regardless of whether the transferor was or is a step and despite the transferor's qualification for, or receipt of, tax benefits deriving from that step relationship.

Likewise, defining a "controlled group of corporations," such as a parent-subsidiary or brother-sister controlled group of corporations,¹³⁸ the statute¹³⁹ applies constructive ownership rules applicable to an individual's blood or adopted "children, grandchildren, parents, and grandparents"¹⁴⁰ and not to her step equivalents.

The statute¹⁴¹ defining S Corporations similarly excludes steps from its definition of a family member.¹⁴² In that statute, family

134. I.R.C. § 318 (2006).

135. I.R.C. § 318(a)(1)(A)(ii) (2006). This language is the same as that found in that same section under the 1954 Code. Pub. L. 591, 83rd Cong., 2nd Sess., 68 Stat. 3, 99-100 (Supp. A 1954). This section was referenced in the 1954 Code to determine constructive ownership in such sections as 302(c)(1) and 304(c)(2). *See id.* at 86-87, 90.

136. I.R.C. § 318(a)(1)(B) (2006).

137. *See, e.g.*, I.R.C. §§ 41(b)(3)(D)(ii); 105(h)(5)(B); 168(h)(6)(F)(iii)(III); 263A(e)(2)(B)(ii); 269A(b)(2); 269B(e)(2)(B); 301(e)(2); 302(c)(1), (2)(A), (B)(i)-(ii), C(ii); 304(b)(1), (3)(B)(iii)(I), (c)(3)(A)-(B); 306(b)(1)(A)(ii), (iii), (c)(4); 338(h)(1), (3)(A)(iii), (C)(iii); 355(d)(8)(A), (e)(4)(C)(ii), (g)(3)(B); 356(a)(2); 367(c)(2); 382(l)(3)(A)(i)-(iv); 409(n)(1)(B), (p)(5)(B); 414(m)(6)(B); 416(i)(1)(B)(i)(I), (iii), (I), (II); 441(i)(2)(B); 453(f)(1)(A), (g)(3) (referring to § 1239(b), which in turn references § 318); 465(c)(7)(D)(iii), E(i); 512(b)(13)(D)(ii); 664(g)(2)(B), (C), (g)(5)(B); 856(d)(5)(A), (B); 871(h)(3)(C)(i), (ii), (iii); 881(b)(3)(B); 897(c)(6)(C); 904(h)(6)(B); 958(b); 1042(b)(2); 1059(e)(1)(A)(ii)(I); 1060(e)(2)(B); 1239(b)(2); 1372(b); 2036(b)(2); 4975(f)(6)(C); 6038(e)(2)(A)-(B) (2006).

138. I.R.C. § 1563(a)(1)-(2) (2006).

139. I.R.C. § 1563 (2006) (enacted by Pub. L. No. 88-272, Title II, § 235(a), 78 Stat. 120 (1964)).

140. I.R.C. § 1563(e)(6)(A)-(C) (2006).

141. I.R.C. § 1361 (2006) (added to the 1954 I.R.C. by the Subchapter S Revision Act of 1982, Pub. L. No. 97-354, § 2, 96 Stat. 1669 (1982)).

142. I.R.C. § 1361(c)(1)(B) (2006) (defining "members of a family" as a common ancestor, his lineal descendants, and the spouses or former spouses of the lineal descendants).

members are treated as one shareholder and, while steps are omitted, that definition encompasses “any eligible foster child of an individual within the meaning of section 152(f)(1)(c)” as a blood-related family member.¹⁴³

Finally, Congress imposes penalties¹⁴⁴ on a wide variety of self-dealing transactions¹⁴⁵ between private foundations and disqualified persons,¹⁴⁶ which includes certain family members.¹⁴⁷ Those family members consist of an individual’s “spouse, ancestors, children, grandchildren, great grandchildren, and the spouses of his children, grandchildren, and great grandchildren.”¹⁴⁸ The rules, moreover, use the related party loss disallowance statute’s family relationships¹⁴⁹ for attribution rules defining entities that are disqualified persons.¹⁵⁰ That means that there are no steps that are considered disqualified persons for the purpose of self-dealing. Yet, these rules were enacted “[i]n order to minimize the need to apply subjective arm’s-length standards, to avoid the temptation to misuse private foundations for noncharitable purposes, to provide a more rational relationship between sanctions and improper acts, and to make it more practical to properly enforce the law”¹⁵¹ The omission of comparable step-relatives from the category of disqualified persons does not make sense today.

By contrast, there are some Code provisions¹⁵² that assist family farm businesses that produce negative tax consequences for steps by omitting them from the definition of family. Enacted in 1976,¹⁵³

143. I.R.C. § 1361(c)(1)(C) (2006).

144. I.R.C. § 4941(a)–(b) (2006).

145. I.R.C. § 4941(d)(1) (2006) (“For purposes of this section, the term “self-dealing” means any direct or indirect—(A) sale or exchange, or leasing, of property between a private foundation and a disqualified person; (B) lending of money or other extension of credit between a private foundation and a disqualified person; (C) furnishing of goods, services, or facilities between a private foundation and a disqualified person; (D) payment of compensation (or payment or reimbursement of expenses) by a private foundation to a disqualified person; (E) transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation; and (F) agreement by a private foundation to make any payment of money or other property to a government official (as defined in section 4946 (c)), other than an agreement to employ such individual for any period after the termination of his government service if such individual is terminating his government service within a 90-day period.”).

146. I.R.C. § 4946(a) (2006). Moreover, I.R.C. § 507(d)(2)(C)(ii) (2006) incorporates I.R.C. § 4946 (2006) disqualified persons in its definition of a related person.

147. I.R.C. § 4946(a)(1)(D) (2006).

148. I.R.C. § 4946(d) (2006).

149. I.R.C. § 267(c)(4) (2006).

150. I.R.C. § 4946(a)(3)–(4) (2006).

151. H.R. 419, 91st Cong. (1969), *reprinted in* 1969 U.S.C.A.N. 1645, 1665.

152. *See, e.g.*, I.R.C. § 447 (2006).

153. Tax Reform Act of 1976, Pub. L. No. 94-455, Title II, § 207(c)(1)(A), 90 Stat. 1538 (1976).

the family farm exception to the requirement of accrual accounting provides small farms with the benefit of using the cash method of accounting, allowing certain farmers to defer taxes.¹⁵⁴ According to that Code provision, a family corporation is one where “at least 50 percent of the total combined voting power of all classes of stock entitled to vote, and at least 50 percent of all other classes of stock of the corporation, are owned by members of the same family.”¹⁵⁵ For that purpose, family members are defined as including the “individual, such individual’s brothers and sisters, the brothers and sisters of such individual’s parents and grandparents, the ancestors and lineal descendants of any of the foregoing, a spouse of any of the foregoing, and the estate of any of the foregoing.”¹⁵⁶ No steps are counted to achieve family corporation status and that entity’s accounting benefits. Similarly, other statutes,¹⁵⁷ which reference that statute¹⁵⁸ to define a “family-owned corporation,”¹⁵⁹ omit steps from their beneficial exception.¹⁶⁰

VI. WEALTH TRANSFER TAXES

A. Estate Tax Benefit Statutes and Steps

For estate taxes, there are two sections reducing a taxpayer’s tax liability where steps are equated with at least some corresponding natural or adopted family members and thereby may reduce their transfer tax liability.¹⁶¹ One of these statutes¹⁶² values the decedent’s family farm, or the real estate connected with a family business, at its

154. H.R. 658, 94th Cong. (1976), *reprinted in* 1976 U.S.C.A.N. 2897, 2989 (“In view of this, your committee believes it is appropriate to require corporations, and certain partnerships, engaged in farming use an accrual method of accounting with the capitalization of certain preproductive period expenses. Your committee, however, has excepted from this requirement certain small or family corporations in order to continue the cash basis method of accounting essentially for all those but the larger corporations engaged in farming.”).

155. I.R.C. § 447(d)(2)(C) (2006).

156. I.R.C. § 447(e) (2006).

157. I.R.C. § 354 (2006).

158. I.R.C. § 447 (2006).

159. *See, e.g.*, I.R.C. § 354(a)(2)(C)(ii)(II) (2006).

160. I.R.C. § 354(a)(1) (2006) provides for the nonrecognition of gain or loss on stock exchanged in a reorganization. I.R.C. § 354(a)(2)(C)(i) (2006) provides that, generally, nonqualified preferred stock shall not be given nonrecognition treatment; however, under I.R.C. § 354(a)(2)(C)(ii) (2006), that limitation shall not apply to a family-owned corporation, as defined in II for that clause.

161. I.R.C. § 2057(d)(2)(B) (2006).

162. I.R.C. § 2032A (2006). This section was added by the Tax Reform Act of 1976, Pub. L. 94-455, Title XX, § 2003(a), 90 Stat. 1856 (1976).

actual use,¹⁶³ rather than at its “highest and best use.” The special, reduced value applies to a member of decedent’s family who is a qualified heir¹⁶⁴ and who continues to use the land for those special purposes for a certain period of time. For the purpose of that Code provision, decedent’s family is defined as including his ancestor, spouse, his or his spouse’s lineal descendant, his parent, or the spouse of any his or his spouse’s lineal descendant.¹⁶⁵ By including his spouse’s lineal descendants as well as their spouses, the decedent’s stepchildren, stepgrandchildren, and stepgreat-grandchildren are treated as the decedent’s own lineal descendants. However, a stepparent, in contrast to a parent, would not qualify in this context.

Further, a short-lived statute, now repealed¹⁶⁶ for decedents dying after 2003,¹⁶⁷ created an estate tax deduction with a maximum amount of \$675,000¹⁶⁸ for the adjusted value of a qualified family-owned business interest of the decedent that is both included in his gross estate and acquired by, or passed from, decedent¹⁶⁹ to a “qualified heir.” The terms “qualified heir”¹⁷⁰ and decedent’s “family members”¹⁷¹ are defined by reference to the definitions used in the estate tax special valuation statute earlier discussed.¹⁷² Moreover, the value of a qualified family-owned business interest under the short-lived statute incorporates a reduction for indebtedness used to pay the educational and medical expenses of the decedent,

163. The allowed reduction may not, however, exceed \$750,000, indexed for inflation. I.R.C. § 2032A (a)(2)–(3) (2006). For decedents dying in 2007, the decrease may not exceed \$940,000. Internal Revenue Service, <http://www.irs.gov/pub/irs-drop/rp-06-53.pdf> (last visited June 13, 2009) (on file with the University of Michigan Journal of Law Reform).

164. That is, a family member who acquired the property from the decedent. *See* I.R.C. § 2032A (e)(1) (2006).

165. I.R.C. § 2032A (e)(2)(A)–(D) (2006).

166. I.R.C. § 2057 (2006). This provision was enacted as § 2033A by Pub. L. 105-34, Title V, § 502(a), 111 Stat. 847 (1997) and renumbered and amended as § 2057 by Pub. L. 105-206, Title VI, § 6007(b), 112 Stat. 807 (1998). *See* H.R. REP. NO. 205-148 (1997) (Conf. Rep.); S. REP. NO. 105-33 (1997) (Conf. Rep.); H.R. REP. NO. 105-220 (1997) (Conf. Rep.).

167. I.R.C. § 2057(j) (2006).

168. This amount was coordinated with the unified credit. I.R.C. § 2057(a)(2)–(3) (2006). Thus, for decedents dying in 2003, the last year of the deduction, “the sum of the QFOBI [section 2057] deduction and the applicable exclusion amount [unified credit] cannot exceed \$1.3 million.” Form 706, Instructions, at 25, col. 2 (Rev. Aug. 2003).

169. I.R.C. § 2057(b)(2) (2006) (stating the business interest must be “acquired by any qualified heir from, or passed to any qualified heir from, the decedent (within the meaning of I.R.C. § 2032A(e)(9)).”).

170. I.R.C. § 2057(i)(1)(A) (2006) (defining a “qualified heir” as in I.R.C. § 2032A(e)(1)).

171. I.R.C. § 2057(i)(2) (2006) (defining a family member as in I.R.C. § 2032A(e)(2)).

172. I.R.C. § 2032A (2006).

her spouse, or dependents, as that last term is categorized by the dependency exemption definitions.¹⁷³

Other provisions that incorporate the definition of family member contained in the estate tax special valuation statute include, besides the temporary estate tax deduction,¹⁷⁴ those that deal with: (1) adequate disclosure to allow the statute of limitations to apply to the transfer for gift tax purposes,¹⁷⁵ (2) exempt organizations,¹⁷⁶ (3) charitable remainder trusts,¹⁷⁷ and (4) qualified conservation easements.¹⁷⁸

Another tax statute¹⁷⁹ enables a decedent's estate to postpone paying estate taxes for the first five years after the decedent's death¹⁸⁰ while also allowing the estate to pay taxes in yearly installments over a ten year period, in years six through fifteen.¹⁸¹

173. I.R.C. § 2057(d)(2)(B) (2006).

174. I.R.C. § 2057(i)(2) (2006).

175. The adequate disclosure statute is I.R.C. § 6501 (2006). Treas. Reg. § 301.6501(c)-1(f)(4) (2006) provides, with respect to the disclosure of non-gifts, if a transfer is made to a member of the donor's family (as defined in section 2032A(e)(2)) "in the ordinary course of operating a business," the transfer is "deemed to be adequately disclosed," even if it is "not reported on the gift tax return," provided that the item is "properly reported by all parties for income tax purposes."

176. See I.R.C. § 501(c)(15)(A)(ii)(II) (2006) (regarding certain non-life insurance companies' employee's family members).

177. I.R.C. §§ 664(g)(2), (g)(3)(F), (g)(5)(A)(i) (2006).

178. I.R.C. § 2031(c)(8)(D) (2006).

179. I.R.C. § 6166 (2006).

180. During the first five years after decedent's death, only interest payments must be made. I.R.C. § 6166(f)(1) (2006).

181. I.R.C. § 6166(a)(1) provides:

If the value of an interest in a closely held business which is included in determining the gross estate of a decedent who was (at the date of his death) a citizen or resident of the United States exceeds 35 percent of the adjusted gross estate, the executor may elect to pay part or all of the tax imposed by section 2001 in 2 or more (but not exceeding 10) equal installments.

I.R.C. § 6166(a)(1) (2006). I.R.C. § 6166(a)(3) (2006) allows for a five year deferral with just interest payments due before the 10-year installment payment period. The predecessor to section 6166 was enacted in 1958 as part of the Small Business Tax Revision Act of 1958 and stated:

[A]lthough not removing any Federal estate tax in these cases, your committee hopes that by spreading out the period over which the estate tax may be paid, it will be possible for the estate tax in most cases to be paid out of earnings of the business, or at least that it will provide the heirs with time to obtain funds to pay the Federal estate tax without upsetting the operation of the business. Your committee believes that this provision is particularly important in preventing corporate mergers and in maintaining a free enterprise system.

H.R. REP. No. 85-2198, 85th Cong., 1st Sess. (1958), *reprinted in* 1959-2 C.B. 709, 713 (Sec. 6 "Installment Payments of Estate Tax Attributable to Investments in Closely Held Business Enterprise"). The House estimated that the revenue loss from this provision would amount

Unfortunately, although estates often take advantage of the benefits of both the estate tax special valuation statute and this provision,¹⁸² steps are accorded different tax treatment under these two sections. Under the statute that defers estate tax payments, the aggregation rules benefit the decedent by allowing her to combine business interests with her family's to qualify for the section's tax relief. However, the definition of family that is used in that statute references the related party loss disallowance section's definition of family members,¹⁸³ with the result that the estate tax postponement statute does not include any steps as part of decedent's family. This lack of aggregation of a step's stock or partnership interest can deny the applicability of this section both initially¹⁸⁴ and its continued application on a subsequent transfer to a step.¹⁸⁵

B. Anti-abuse Gift Tax Statutes and Steps

In 1990, Congress enacted legislation¹⁸⁶ to discourage unrealistic valuations of gifts of partial business and other property interests where the transferor or applicable family members continued to hold an interest in the business or other property. In addition, these statutes addressed unrealistic values then rampant in family

to approximately \$35 million in the first full year of operation. *See* Estate of Roski v. Comm'r, 128 T.C. No. 10, 26–27 (2007) (“Congress enacted section 6166 because the existing law was ‘inadequate to deal with the liquidity problems experienced by estates in which a substantial portion of the assets consist of a closely held business.’ H.R. 94-1380, at 30 (1976), 1976-3 C.B. (Vol. 3) 735, 764 . . .”).

182. Like section 2032A, section 6166 was also added by the Tax Reform Act of 1976, Pub. L. 94-455, Title XX, § 2004(a), 90 Stat. 1862 (1976). *See* BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES, AND GIFTS ¶ 137.5.1, at 1 (RIA 2007) (“Another tax concession, similarly rationalized as a method of preserving family enterprises, is the election to value the real property of a farm or other business under § 2032A by reference to its current use, rather than its normal market value. Both sections can be used if their separate requirements are met.”); KATHRYN G. HENKEL, ESTATE PLANNING AND WEALTH PRESERVATION: STRATEGIES & SOLUTIONS ¶ 46.02[7], at 7 (RIA 2007) (“Section 6166 can be used in combination with section 2032A. The qualification and acceleration requirements are not the same for these two sections and so each must be separately examined whenever an issue involving both matters arises.”).

183. I.R.C. § 267(c)(4) (2006).

184. *See* I.R.C. § 6166(b)(2)(D) (2006) (for the purposes of paragraph (1), “All stock and all partnership interests held by the decedent or by any member of his family (within the meaning of section 267(c)(4)) shall be treated as owned by the decedent.”).

185. *See* I.R.C. § 6166(g)(1)(D) (2006). A transfer of the property may accelerate the payment of decedent's estate tax liability; however, if the transferee is a member of the transferor's family, there is an exception to this immediate payment due. Again, this section refers to the definition of family members under I.R.C. § 267(c)(4) (2006), so that a transfer to a step will not fall under this special safe harbor exception.

186. Chapter 14 was added by the Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, § 11602(a), 104 Stat. 1388, and codified as I.R.C. §§ 2701–2704 (2006).

agreements and restrictions. According to the legislative history, “the Committee [was] concerned about the undervaluation of gifts valued pursuant to the Treasury tables Because the taxpayer decides what property to give, when to give it, and often controls the return on the property, use of the Treasury tables undervalues the transferred interests in the aggregate, more often than not.”¹⁸⁷

The first statute enacted in this legislation¹⁸⁸ deals with family business transfers of interests likely to appreciate (e.g., common stock) from the older generation to the younger generation with the older generation retaining an interest frozen in value, such as voting preferred stock (“applicable retained interest”).¹⁸⁹ For the purposes of this section, the transferor’s family consists of her spouse, her or her spouse’s lineal descendant, and the descendant’s spouse¹⁹⁰ and her “applicable family member” includes her spouse, her or her spouse’s ancestor, or that ancestor’s spouse.¹⁹¹ Legally adopted individuals are treated the same as blood relatives.¹⁹² Thus, transfers to the transferor’s stepchildren, stepgrandchildren, or stepgreat-grandchildren are subject to the anti-abuse rules of this statute; the transferor’s stepparents and stepgrandparents, however, are not, although parents-in-law and similar ancestral in-laws are covered by this anti-abuse provision.

The second statute enacted in the 1990 legislation¹⁹³ defines gifts and their value when a partial interest in the same property is transferred to family members. Unless the retained interest is a qualified one,¹⁹⁴ it is valued at zero, to the effect that the donor is taxed on a gift of the total value of the property¹⁹⁵ despite having

187. Report on Omnibus Budget Reconciliation Act of 1990, S. 3209, 101st Cong., 136 Cong. Rec. 30485, 30538 (1990) (enacted).

188. I.R.C. § 2701 (2006).

189. I.R.C. § 2701(b)(1) (2006) (defining an “applicable retained interest” as “any interest in an entity with respect to which there is—(A) a distribution right, but only if, immediately before the transfer described in subsection (a)(1), the transferor and applicable family members hold (after application of subsection (e)(3)) control of the entity, or (B) a liquidation, put, call, or conversion right.”).

190. I.R.C. § 2701(e)(1) (2006).

191. I.R.C. § 2701(e)(2) (2006).

192. I.R.C. § 2701(e)(4) (2006).

193. I.R.C. § 2702 (2006).

194. A qualified interest must be in the form of a qualified annuity, unitrust or qualified remainder interest. I.R.C. § 2702(b) (2006). A qualified interest is valued under § 7520. *See* Treas. Reg. § 25.2702-3(b)-(d) (2008).

195. I.R.C. § 2702 (2006) applies to transfers to “a member of the transferor’s family” (i.e., the donor’s spouse, his (or his spouse’s) ancestor or lineal descendant, his sibling (or his sibling’s spouse)) where the transferor or “applicable family member” (i.e., the transferor’s spouse, his ancestor, or his ancestor’s spouse) retains an interest in a trust or in property treated as if held in a trust. *See* I.R.C. §§ 2702(e), 2704(c)(2), 2701(e)(2), 2702(c)(1), 2702(a)(3)(ii) (2006); *see also* Treas. Reg. § 25.2702-5 (2008). To the extent that § 2702 applies, the decedent must retain his income interest in the form of a qualified inter-

actually transferred only a partial property interest. For the purposes of this provision, family members include an individual's spouse, sibling, any ancestor or lineal descendant of the individual or his spouse, or any spouse of a sibling, ancestor or lineal descendant of the individual or his spouse.¹⁹⁶ Thus, while expanded in comparison to the definition under the gift tax family business transfers valuation statute¹⁹⁷ to include the individual's siblings and their spouses, this definition does not provide coverage for any steprelatives. Applicable family members under these two sections are defined precisely the same; neither includes the transferor's stepancestors.¹⁹⁸

The third statute enacted in this 1990 legislation¹⁹⁹ allows the value stated in certain agreements, options, rights or restrictions to control when transferred to family members or other "natural objects of the transferor's bounty" only where that value satisfies certain requirements, including where the agreement is not a testamentary device but a bona fide business arrangement. This provision is unusual in that, under the regulations, the transferees encompassed in its rules extend beyond members of the family and specifically include non-family members in its definition of "the natural objects of the transferor's bounty."²⁰⁰ Stepchildren are included in the definition of family member,²⁰¹ but other steps may also be included under the definition of "the natural objects of the bounty." The regulations under this section define the transferor's family to include the same individuals as those described in the gift tax family business transfers valuation statute²⁰² as family members²⁰³ and, therefore, embrace the lineal descendants of the transferor's spouse.

The regulations under this third statute do not define the "natural objects of the transferor's bounty," but, in promulgating the regulations, the IRS explained that the phrase need not be restricted to those who are related by blood or marriage, but re-

est or his retained interest will be valued at zero. I.R.C. § 2702(a)(2)(A) (2006). This means the value of any retained nonqualified interest is valued at zero. *See* Treas. Reg. § 25.2702-3(f)(iii) (2008) ("[A]n interest is non-contingent only if it is payable to the beneficiary or the beneficiary's estate in all events.").

196. I.R.C. § 2702 (e) which defines family members under I.R.C. § 2704 (c)(2). *See* Treas. Reg. § 25.2702-2(a)(1) (2006).

197. I.R.C. § 2701 (2006).

198. I.R.C. § 2702(a)(1) refers to the definition in § 2701(e)(2). *See* Treas. Reg. § 25.2701-1(d)(2) (2008).

199. I.R.C. § 2703 (2006).

200. Treas. Reg. § 25.2703-1(b)(3) (2008).

201. *See* I.R.S. Tech. Adv. Mem. 9841005, 1998 WL 700563 (June 4, 1998).

202. I.R.C. § 2701 (2006).

203. Treas. Reg. §§ 25.2703-1(b)(3), 25.2701-2(b)(5) (2008).

flects the “concept [that] has long been part of the transfer tax system”²⁰⁴ That term—natural objects of the transferor’s bounty—has been described as “a somewhat elusive concept not admitting of one clear definition that would apply to all cases, but rather one best decided on a case-by-case basis.”²⁰⁵ When applying the term, the court needs to find sufficient evidence “to suggest that an unrelated party shares a relationship with decedent such as to be effectively considered a member of the family.”²⁰⁶

Finally, the fourth statute enacted in the 1990 legislation ignores the value of certain lapsing rights or certain restrictions in a family business unless those limitations represent actual qualifications of the business interests. For the purpose of determining an “applicable retained interest,” this statute requires looking to the gift tax family business transfers valuation statute²⁰⁷ under which control means holding at least fifty percent (by vote or value) of the corporate stock,²⁰⁸ at least fifty percent of the capital or profits interest in a partnership,²⁰⁹ or a general partner interest in a limited partnership.²¹⁰ Moreover, to the extent that an interest is held indirectly by an individual through a corporation, partnership, trust, or other entity, it is attributable to that individual.²¹¹ This fourth provision first deems a lapse of corporate or partnership voting or liquidation rights in a controlled²¹² entity as a gift or bequest,²¹³ computed by taking the

204. Special Valuation Rules, 57 Fed. Reg. 4250, 4253 (1992) (“One commentator requested that the final regulations define the term ‘natural objects of the bounty.’ The final regulations do not provide a definition of this term. This concept has long been part of the transfer tax system and cannot be reduced to a simple formula or specific class of relationship. The class of persons who may be the objects of an individual’s bounty is not necessarily limited to persons related by blood or marriage.”).

205. *Gloekner v. Comm’r*, 152 F.3d 208, 210 (2d Cir. 1998), *rev’g* T.C. Mem. 1996–148 (1996).

206. *Id.* at 215. In *Gloekner v. Comm’r*, the court ruled that two loans and being a minor beneficiary in decedent’s will were insufficient evidence that decedent and a business associate had a close personal relationship. In dicta, however, the court stated:

In this respect we do not foreclose the possibility that the existence of past transfers of property at significantly less than market value, or of arrangements designed to do the same, might, in appropriate circumstances, give rise to an inference that the transferee was effectively considered a member of decedent’s family.

Id.

207. I.R.C. § 2701 (2006).

208. I.R.C. § 2701(b)(2)(A) (2006).

209. I.R.C. § 2701(b)(2)(B)(i) (2006).

210. I.R.C. § 2701(b)(2)(B)(ii) (2006).

211. I.R.C. § 2701(e)(3) (2006). If such attribution applies, “any transfer which results in such interest being treated as no longer held by such individual shall be treated as a transfer of such interest.” *Id.*

212. Control is defined under I.R.C. § 2704(c)(1) by I.R.C. § 2701(b)(2) (2006).

excess of the value, undiscounted for these rights, of all her entity interests immediately before the lapse over their value immediately after the lapse.²¹⁴ Second, this statute contains rules requiring that certain restrictions or liquidation rights be disregarded in the context of a family transfer of a corporate or partnership interest.²¹⁵ Exempt from this second rule are “any commercially reasonable restrictions” stemming from the entity’s financing with an unrelated person²¹⁶ or a restriction required by law.²¹⁷ With respect to these provisions, family is defined as the individual’s spouse, an ancestor or lineal descendant of the individual or spouse, the individual’s sibling, or any spouse of that ancestor, lineal descendant, or sibling.²¹⁸ Thus, again, stepchildren, stepgrandchildren, and stepgreat-grandchildren are included in this list while the transferor’s stepascendants or stepsiblings are not. Finally, the attribution rules applied here are those applicable under the gift tax family business transfers valuation statute.²¹⁹

C. Generation Skipping Transfer Tax Statutes and Steps

The current generation skipping transfer tax (GSTT) was enacted in 1986²²⁰ and applies to transfers to “skip persons” who may or may not be family members, but who in general belong to at least one’s grandchildren’s generation. They are described as “skip persons” because the transfer to them is one that otherwise would avoid one generation of transfer taxes (i.e., either gift or estate taxes). To determine whether that an individual is a “skip person” and skips a generation (or more than one generation) of taxes, the GSTT assigns individuals to a generation and that classification differs depending on whether the person is a lineal descendant of the transferor²²¹ or the transferor’s spouse (or for-

213. I.R.C. § 2704(a)(1) (2006).

214. I.R.C. § 2704(a)(2) (2006).

215. I.R.C. § 2704(b)(1) (2006).

216. I.R.C. § 2704 (b)(3)(A) (2006) (i.e., a person not related to either the transferor or transferee or to either of their family members).

217. I.R.C. § 2704(b)(3)(B) (2006).

218. I.R.C. § 2704(c)(2) (2006).

219. I.R.C. § 2701(b)(2), (e)(3) (2006).

220. The first GSTT was enacted in 1976 and was repealed and replaced by the 1986 version. Pub. L. No. 94-455, Title XX, § 2006(a), 90 Stat. 1879 (1977), *repealed by* Pub. L. No. 99-514, § 1433(c), and *amended by* Pub. L. No. 99-514, Title XIV, § 1431(a), 100 Stat. 2718. *See* H.R. REP. No. 99-841 (1986) (Conf. Rep.).

221. I.R.C. § 2651(b)(1) (2006).

mer spouse),²²² or of another relation.²²³ Family relationships include those created by blood, half-blood, adoption, and marriage (current or former).²²⁴ There is a special rule on adoption since it would be easy to shift generations by means of adoption, particularly with respect to adult grandchildren.²²⁵ Thus, for determining generation assignment, not only must the adopted individual be legally adopted, but he must be both younger than eighteen years old when adopted²²⁶ and “not adopted primarily for the purposes of avoiding” the GSTT.²²⁷ Divorced individuals retain the same generation assignment they had when they were married, as do their descendants.²²⁸ Thus, family members for GSTT purposes include stepchildren and their spouses as well as stepgrandchildren and their spouses, etc. Ex-spouse’s parents and ex-spouse’s grandparents continue to be considered part of the transferor’s family, but the transferor’s own stepparent or stepgrandparents are not.

While the GSTT includes a lot of different relations as family members, including those related to his former spouse and, therefore, some steps, it is surprising that former in-laws, including new members of his in-laws’ family, are treated as more closely related than a stepbrother or stepniece or stepgrandnephew even when the transferor has voluntarily made a gift to him or her.

VII. A UNIFORM RULE

The sections above demonstrate the disparate ways the Tax Code treats steprelatives. This Article recommends that Congress include

222. I.R.C. § 2651(b)(2) (2006) (“An individual who is a lineal descendant of a grandparent of a spouse (or former spouse) of the transferor (other than such spouse) shall be assigned to that generation which results from comparing the number of generations between such grandparent and such individual with the number of generations between such grandparent and such spouse.”).

223. I.R.C. § 2651(d) (2006). Unrelated individuals are assigned to a generation by their age difference to the transferor: those not more than 12 ½ years younger than the transferor’s generation are members of his generation, those more than 12 ½ but not more than 37 ½ years younger than the transferor are members of the generation right below the transferor (like his child), those more than 37 ½ but not more than 62 ½ years younger than the transferor are assigned to the generation two generations below him and so on for each 25 years thereafter. *Id.*

224. I.R.C. §§ 2651(b)(3), 2651(c) (2006).

225. Treas. Reg. § 26.2651-2(b) (2005). The example given in the regulation is one in which the transferor adopts her twenty-year-old grandchild. The example concludes that, despite the adoption, the grandchild remains a skip person and that the transfer from the transferor to the grandchild remains a direct skip. *Id.*

226. Treas. Reg. § 26.2651-2(b)(3) (2005).

227. Treas. Reg. § 26.2651-2(b)(4) (2005).

228. I.R.C. §§ 2651(c), 2651(b)(2) (2006).

steps as counterparts to the current blood and adopted relatives listed in each of the Code's major sections defining family.²²⁹ The application of each of those sections incorporates a situation that involves a transfer or other voluntary action between steps or presents a circumstance with abuse potential that makes such a designation prudent at least during the step's marriage to the step's biological or adoptive relative. This recommendation is simple to apply and affords the same familial treatment to steps as is currently available to them in many income tax benefit sections.

At the opposite extreme, Congress can fashion a "facts and circumstances" test to determine which steps should be considered as family members for all tax purposes. If Congress wanted to adopt a more fluid definition despite the potential for increased litigation,²³⁰ the regulations regarding adoptions for GSTT purposes²³¹ provide a good list of criteria that could be applied to define a step relationship as family. "The most significant factor for those GSTT purposes is whether there is a bona fide parent/child relationship between the adoptive parent and the adopted individual, in which the adoptive parent has fully assumed all significant responsibilities

229. I.R.C. §§ 267, 318, 447, 707(b), 1361, 1563, 2032A, 2651, 2701(e), 2704(c) (2006). On the one hand, there is a good argument that a uniform definition of family members for all tax purposes should be a broad one. The fairly recently enacted qualified tuition plans statute provides a good prototype for an expansive definition of family: spouse, child or stepchild (or either's descendants), lineal ancestors, stepparents, siblings or stepsiblings (or either's children), aunts and uncles, first cousins, and certain in-laws. I.R.C. § 529 (2006). See *supra* notes 90–97 and accompanying text. Moreover, such a wide-ranging list would complement other current, related legislation. The 2004 uniform definition of "child" for the purposes of five Code sections is likewise broad and includes many steps (and in-laws) as relatives: the taxpayer's son, daughter, stepson, or stepdaughter (or any of their descendants); brother, sister, stepbrother or stepsister (or any of their descendants); father or mother or an ancestor or sibling of either; stepfather or stepmother; and son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law or sister in law. I.R.C. § 152(a)(1)–(2), (c)(2), (d)(2)(A)–(G), (f)(1)(A)(i), (4) (2006). Of course, inexplicably lacking from this list are stepgrandparents (or any ancestor of either a stepfather or stepmother), steppaunts or stepuncles, or stepin-laws comparable to those blood or adopted "qualifying relatives." On the other hand, it would be premature for this paper to recommend such a sweeping change that would expand not only all of the current Code sections to steps, but also the definition of family members for all tax contexts. Before making that kind of recommendation, there should be an analysis of its effects on each provision, especially an economic analysis of the costs, and of its comportment with each statute's legislative purpose. That kind of review is beyond the limits of this Article.

230. For tax purposes, my preference is to ignore actual relationships so that it is easier to apply the tax rule and the result is less likely to be subject to litigation. An individual may hate their biological parent, for example, but that would be irrelevant for attribution or wealth transfer purposes. For those who like facts and circumstances tests, however, the one applied to GSTT adoptions appears to be suitable in this context.

231. The definition of "adopted individual" under Treas. Reg. § 26.2651-2(b) (2005), although a facts and circumstances analysis, is clearly necessary since adult adoption of grandchildren would become commonplace in order to alter generation assignment and avoid the GSTT.

for the care and raising of the adoptive child."²³² Another important factor is the age of the child when adopted (the younger the better).²³³

Alternatively, and somewhere between these two suggestions, Congress can adopt a rule acknowledging step relationships that are most likely to exhibit family ties. A step relationship, which is most likely to be characterized as family-like, is one that was created during a stepchild's minority, either before age eighteen or earlier, such as before age fourteen. If there is such a step relationship at the core, all relatives of the stepchild that are included in the list of family members under the applicable Code section defining family would be covered by that tax provision.

A final possibility to define a step as a family member, without using an age benchmark, might be to focus on a step's actions: either a step's voluntarily transferring assets to her step relation or a step's enjoying certain tax benefits for that step.²³⁴ Any one voluntary action would make the step a family member under all of the tax statutes and that step's relatives would also be included under the applicable list of family members.

VIII. CONCLUSION

Currently, steps may receive favorable tax treatment under many income tax benefit sections. Among the many tax advantages for which steps may qualify are the earned income tax and

232. *Id.*

233. Treas. Reg. § 26.2651-2(b)(4)(i) (2005). Likewise, in the GSTT context, the government considers the relationship between the adopted child and their natural parents—their "absence or incapacity," for example, may indicate a non-GSTT motivation. *See* Treas. Reg. § 26.2651-2(b)(4)(ii) (2005).

234. Clearly, the voluntary transfer of assets indicates a relationship between steps that parallels their natural and adopted counterparts. Although less patent, the ability to claim tax benefits for a step also implies such an affinity; at any rate, during a marriage, it would be inconsistent and affect a double benefit to treat this action in any other way. Contrast those easily identifiable relationships of steps to the unclear relationships involved in using the term "objects of the . . . bounty" contained in the regulations under one of the statutes enacted in the 1990 gift tax legislation. I.R.C. § 2703 (2006); Treas. Reg. § 25.2703-1(b)(3) (2008). One of the main components of testamentary capacity is that the testator must know "the natural objects of his or her bounty." *RESTATEMENT (THIRD) OF PROPERTY* § 8.1 (2003). *See* Frances H. Foster, *The Family Paradigm of Inheritance Law*, 80 N.C. L. REV. 199, 207 (2001); Susan N. Gary, *Mediation and the Elderly: Using Mediation to Resolve Probate Disputes over Guardianship and Inheritance*, 32 WAKE FOREST L. REV. 397, 418, n.127 (1997); Jan E. Rein, *Relatives by Blood, Adoption, and Association: Who Should Get What and Why*, 37 VAND. L. REV. 711, 763–765 (1984). Although concededly long-applied in the trusts and estates area, because that term requires an individual analysis of many facets of a relationship, it is more likely to invite litigation than determining who is a step and whether he is the gratuitous transferee of a property or entity interest. *See supra* notes 199–206.

dependent care credits, dependency exemption deductions, and various fringe, education, legal, and medical benefits.²³⁵ However, steps are not presently treated as family members for corporate entity or wealth transfer tax purposes and they therefore benefit tax-wise from the omission. For equity and uniformity, the substance of their family relationship as construed by their voluntary acts that resemble their biological equivalents should be recognized by the Tax Code for those purposes as well.

There is no requirement that wealthy and powerful individuals share their property with their steps and it is not the purpose of this Article to suggest that they do so, but if they do, they are giving rise to a relationship that is no different from the natural or adoptive parent/child or other statutorily applicable family relationship and that fact should be reflected in the Tax Code. Moreover, a step relationship, once established, should continue to be recognized for some tax purposes even when the marriage creating the step relationship has ended due to separation, divorce or death.²³⁶ It is the voluntary transfer of property, the voluntary acceptance of benefits derived from the step relationship, or the voluntary sharing of corporate control, from a donor or decedent to a current or former step, that highlights the equivalence of the step relationship with its natural or adoptive counterpart.²³⁷

This Article recommends that steps be included as counterparts to the current blood and adopted relatives in each of the major Code sections defining family,²³⁸ but also offers alternative solutions narrowing the list of steps included in the definition. While much of the literature is wrestling with definitions of family for non-traditional families, it is long overdue to consider at least some steps as family members for *all* tax purposes. Currently, many steps enjoy tax benefits resulting from their inclusion or exclusion in the definition of family. It is both reasonable and equitable to classify steps as family for corporate attribution rules and wealth transfer tax purposes as well.

235. See *supra* Part IV.A.

236. See *supra* Part II.

237. This proposal is consistent with the movement in family law that views parenting responsibilities in line with familial behavior. Thus, the A.L.I. definition of parent includes a parent by estoppel or a de facto parent. See *supra* note 5, § 2.03.

238. See, e.g., I.R.C. §§ 267, 318, 447, 707(b), 1361, 1563, 2032A, 2651, 2701(e), 2704 (c) (2006).