

1993

Common Sense and the Gift Tax Annual Exclusion

John G. Steinkamp

University of Arkansas School of Law

Follow this and additional works at: <https://digitalcommons.unl.edu/nlr>

Recommended Citation

John G. Steinkamp, *Common Sense and the Gift Tax Annual Exclusion*, 72 Neb. L. Rev. (1993)

Available at: <https://digitalcommons.unl.edu/nlr/vol72/iss1/4>

This Article is brought to you for free and open access by the Law, College of at DigitalCommons@University of Nebraska - Lincoln. It has been accepted for inclusion in Nebraska Law Review by an authorized administrator of DigitalCommons@University of Nebraska - Lincoln.

John G. Steinkamp*

Common Sense and the Gift Tax Annual Exclusion

TABLE OF CONTENTS

I. The Federal Gift Tax	110
A. Legislative History	110
B. Transfers Subject to Taxation.....	113
II. The Annual Exclusion	116
A. Reasons for the Exclusion	116
B. Annual Exclusion Amount	118
C. Future Interest Limitation	119
D. Burden of Proof.....	125
III. Availability of the Annual Exclusion for Certain Transfers	128
A. Income Interests	129
B. Indirect Outright Transfers	134
1. Reciprocal Gifts.....	134
2. Gifts Through Intermediaries	135
C. Nonlapsing Demand Powers	137
D. Lapsing Demand Powers.....	145
1. <i>Crummey v. Commissioner</i>	145
2. Internal Revenue Service's Post- <i>Crummey</i> Position	151
3. Reciprocal Lapsing Demand Powers.....	153
E. Naked and Semi-Naked Lapsing Demand Powers	155
1. Internal Revenue Service's Position	155
2. <i>Estate of Cristofani v. Commissioner</i>	159
3. Post- <i>Cristofani</i> Developments	165
IV. Annual Exclusion Reform	167
A. The Need for Reform	167
B. Proposed Reform.....	169
1. The Annual Exclusion Amount	169
2. Qualifying Interests.....	172
C. Judicial Implementation	176
D. Legislative Implementation	177
V. Conclusion	178

Copyright held by NEBRASKA LAW REVIEW.

* Assistant Professor of Law, University of Arkansas School of Law, Fayetteville, Ark.; B.A., University of Illinois; J.D., University of Colorado School of Law; LL.M. (Taxation), University of Denver College of Law.

If one were drafting a gift tax statute ab initio, transfers of property below a certain value would be exempted in order to make the tax politically acceptable and administratively workable.¹ The annual exclusion provided by Internal Revenue Code § 2503(b)² furnishes such an exemption under current federal tax law. The exclusion affords taxpayers valuable relief from the gift and estate tax system.³ Every individual may make unlimited gifts of present interests in property having an aggregate value of \$10,000 per donee each calendar year without having to pay any gift tax⁴ or file a gift tax return.⁵ Substantial amounts can be transferred free of gift and estate taxation through use of the annual exclusion.⁶

Any provision that offers complete exemption from taxation and is provided on an annual, noncumulative basis is apt to encourage usage. Taxpayers, not surprisingly, have sought to obtain the maximum benefit of the annual exclusion. The exclusion is one of the reasons lifetime gifting is perhaps the most important device available to reduce transfer taxation.⁷

1. W. LESLIE PEAT & STEPHANIE J. WILLBANKS, FEDERAL ESTATE AND GIFT TAXATION: AN ANALYSIS AND CRITIQUE § 7.06, at 92 (1991).

2. I.R.C. § 2503(b). The text of the provision is as follows:

Exclusion from gifts. — In the case of gifts (other than gifts of future interests in property) made to any person by the donor during the calendar year, the first \$10,000 of such gifts to such person shall not, for purposes of subsection (a), be included in the total amount of gifts made during such year. Where there has been a transfer to any person of a present interest in property, the possibility that such interest may be diminished by the exercise of a power shall be disregarded in applying this subsection, if no part of such interest will at any time pass to any other person.

All references herein are to the Internal Revenue Code of 1986, as amended and in effect on the date of this article, unless otherwise indicated.

3. See text accompanying notes 466-70 *infra*. Although the annual exclusion protects property transferred from gift taxation, certain transferred property may, nonetheless, be included in donor's gross estate for estate tax purposes. See I.R.C. §§ 2035-2038.

4. See I.R.C. §§ 2501, 2503.

5. I.R.C. § 6019 (providing that any individual who, in any calendar year, makes a transfer by gift, other than transfers excluded by the annual exclusion under § 2503(b), the tuition and medical expense exclusion under § 2503(e), or for which the marital deduction is allowed under § 2523, shall file a gift tax return for such year).

6. See text accompanying notes 466-70 *infra*.

7. See George Cooper, *A Voluntary Tax? New Perspectives on Sophisticated Estate Tax Avoidance*, 77 COLUM. L. REV. 161, 191 (1977); Louis S. Harrison, *The Strategic Use of Lifetime Gifting Programs To Reduce Estate Taxes in Light of Recent Congressional and Internal Revenue Service Antipathy Towards Transfer Tax Reduction Devices*, 40 DE PAUL L. REV. 365, 366 (1991); John R. Price, *Intrafamily Transfers: Blessed and More Blessed Ways to Give*, 18 INST. ON EST. PLAN. 6-1, 6-2 (1984). See also Owen G. Fiore & John F. Ramsbacher, *Crummey Powers for Contingent Beneficiaries OK'd*, 19 EST. PLAN. 10, 10 (1992); Richard

Maximum benefit of the annual exclusion, however, has often been sought for interests or in circumstances that raise questions regarding the proper limits of the exclusion.⁸ Donors have not been content to make outright transfers of property to donees. Many have transferred property in trusts and created numerous equitable interests for which the annual exclusion has been claimed.⁹ The question of whether the transfer of particular interests qualifies for the exclusion has resulted in much litigation¹⁰ and numerous administrative rulings.¹¹

While taxpayers are entitled to make maximum use of tax deductions and exclusions in order to minimize or avoid taxes,¹² the annual exclusion is a matter of legislative grace and is to be strictly construed.¹³ The exclusion should not be allowed for interests or in circumstances that are inconsistent with the purposes that supported its enactment. Form should not be allowed to prevail over substance.¹⁴

W. Harris & Steven W. Jacobson, *Maximizing the Effectiveness of the Annual Gift Exclusion*, 70 TAXES 204, 204 (1992).

8. See Cooper, *supra* note 7, at 234-35.
9. See, e.g., *Crummey v. Commissioner*, 397 F.2d 82 (9th Cir. 1968); *Estate of Cristofani v. Commissioner*, 97 T.C. 74 (1991), *acq. in result*, 1992-1 C.B. 1.
10. Jeffrey G. Sherman, *'Tis a Gift to be Simple: The Need for a New Definition of "Future Interest" for Gift Tax Purposes*, 55 U. CIN. L. REV. 585, 585 (1987) ("The most troublesome and most frequently litigated issue in gift tax law is undoubtedly the availability of the 'annual exclusion' authorized by section 2503(b).") (footnote omitted); see also Albert Krassner, *The Trouble Spots of the Gift Tax: A Haunting Ground for the Tax Planner*, 22 J. TAX'N 346, 346 (1965).
11. See, e.g., Rev. Rul. 85-24, 1985-1 C.B. 329; Rev. Rul. 83-108, 1983-2 C.B. 168; Rev. Rul. 81-7, 1981-1 C.B. 474; Rev. Rul. 80-261, 1980-2 C.B. 279; Rev. Rul. 79-47, 1979-1 C.B. 312; Rev. Rul. 76-360, 1976-2 C.B. 298; Rev. Rul. 75-506, 1975-2 C.B. 375; Rev. Rul. 75-415, 1975-2 C.B. 374; Rev. Rul. 73-405, 1973-2 C.B. 321; see also L. Henry Gissel, Jr. & Robert J. Rosepink, *Irrevocable Trusts and Crummey Powers*, 15 PROB. NOTES 128 (1989) (reviewing numerous administrative rulings issued in connection with demand powers).
12. *Gregory v. Helvering*, 293 U.S. 465, 469 (1935) ("The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted.") (citations omitted); see *Johnson v. Commissioner*, 86 F.2d 710, 712 (2d Cir. 1936); *Perkins v. Commissioner*, 27 T.C. 601, 606 (1956).
13. *Estate of Levine v. Commissioner*, 526 F.2d 717, 721 (2d Cir. 1975) ("[W]e cannot be unmindful of the rule of construction that Congress permits exclusions only as a matter of grace, and the exclusions sections are to be strictly construed against the taxpayer. See *Standard Oil Co. v. United States*, 338 F.2d 4, 8 (2d Cir. 1964); *Bingler v. Johnson*, 394 U.S. 741, 752, 89 S.Ct. 1439, 22 L.Ed.2d 695 (1969)."); *Gilmore v. Commissioner*, 20 T.C. 579, 586 (1953), *rev'd on other grounds*, 213 F.2d 520 (6th Cir. 1954) ("Section 1003(b)(3) [the annual exclusion] grants an exclusion which amounts to a tax exemption and must therefore be strictly construed.") (citation omitted); cf. *Helvering v. Northwest Steel Rolling Mills*, 311 U.S. 46, 49 (1940).
14. The Supreme Court has long recognized the substance over form doctrine in tax matters. In *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978) the Court held: In applying this doctrine of substance over form, the Court has looked to the objective economic realities of a transaction rather than to the partic-

The Internal Revenue Service and the courts should use common sense in deciding whether a transfer qualifies for the exclusion. Failure to do so undermines the estate and income tax protective purpose of the gift tax.¹⁵

The gift tax supports the estate tax and the annual exclusion provides a necessary, but limited, exemption from the gift tax. The exclusion should allow taxpayers to make customary and occasional gifts of relatively small value without triggering the gift tax or its reporting requirements. It should be a simple provision that easily accomplishes its limited objectives. It should not encourage lifetime transfers in lieu of death transfers in order to reduce estate taxes. The annual exclusion, however, has proved to be anything but simple, and significant estate tax avoidance possibilities exist through routine use of the exclusion.¹⁶

Recent administrative announcements¹⁷ and court decisions¹⁸ provide the occasion for reconsidering the annual exclusion. This article will examine the role of the exclusion in the gift and estate tax system, the purposes that supported its enactment, and the availability of the exclusion for certain transfers. I conclude that the annual exclusion is currently allowed for transfers of certain interests that are inconsistent with the original limited purposes of the exclusion and that such allowances impair the estate tax protective function of the gift tax. Annual exclusion reform will be proposed.

ular form the parties employed. The Court has never regarded "the simple expedient of drawing up papers," *Commissioner v. Tower*, 327 U.S. 280, 291 (1946), as controlling for tax purposes when the objective economic realities are to the contrary.

Id. at 573.

In *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945) the Court expounded:

The incidence of taxation depends upon the substance of a transaction. . . . A sale by one person cannot be transformed for tax purposes into a sale by another by using the latter as a conduit through which to pass title. To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress.

Id. at 334 (footnote omitted); *see also* *Gregory v. Helvering*, 293 U.S. 465, 469-70 (1935).

15. *Cf.* *Dickman v. Commissioner*, 465 U.S. 330, 338 (1984).

16. *See* text accompanying notes 466-70 *infra*.

17. *See, e.g.*, Tech. Adv. Mem. 91-41-008 (June 24, 1991); Tech. Adv. Mem. 90-45-002 (July 27, 1990); Priv. Ltr. Rul. 90-30-005 (Apr. 19, 1990); Tech. Adv. Mem. 87-27-003 (Mar. 16, 1987).

18. *See, e.g.*, *Heyen v. United States*, 945 F.2d 359 (10th Cir. 1991); *Estate of Cristofani v. Commissioner*, 97 T.C. 74 (1991), *acq. in result*, 1992-1 C.B. 1.

I. THE FEDERAL GIFT TAX

A. Legislative History¹⁹

The federal estate tax was enacted in 1916.²⁰ The tax, however, was not accompanied by a gift tax and could generally be avoided by gift transfers during life.²¹ Congress partially addressed this estate tax avoidance problem by requiring that the value of property transferred "in contemplation of death" be included in decedents' gross estates for estate tax purposes.²² Scrutiny of the circumstances surrounding inter vivos transfers, however, imposed a heavy burden on tax administrators.²³ "Life motives" and "death motives" were used by courts in determining whether transfers had been made "in contemplation of death."²⁴ The results under this approach were unsatisfactory²⁵ and contributed to enactment of a federal gift tax²⁶ in 1924²⁷ as a necessary corollary to estate and income taxes.²⁸

The 1924 gift tax was determined annually and was not cumulative.²⁹ A \$50,000 annual exemption³⁰ and a \$500 per donee annual exclusion³¹ were provided. The gift tax, consequently, could be avoided by spreading gifts over several years using the large annual exemption.³²

The gift tax was repealed as of January 1, 1926,³³ as part of an overall reduction in federal taxes after the federal government's fiscal health improved.³⁴ The depression that occurred shortly thereafter,

19. See Bradford L. Ferguson, Frederic W. Hickman & Donald C. Lubick, *Reexamining the Nature and Role of Tax Legislative History in Light of the Changing Realities of the Process*, 67 TAXES 804, 804 (1989) ("Analysis almost invariably starts with the proposition that it is the statute alone that is 'the law.' 'Legislative history' is generally agreed to be controlling to the extent that it *legitimately* helps to *discover the original meaning* that the statutory words were intended to carry.").

20. Revenue Act of 1916, Pub. L. No. 64-271, §§ 200-212, 39 Stat. 756, 777-80.

21. LEWIS D. SOLOMON, IRA M. BLOOM & JOHN T. GAUBATZ, *FEDERAL TAXATION OF ESTATES, TRUSTS AND GIFTS* § 1.01, at 4 (1989).

22. Revenue Act of 1916, Pub. L. No. 64-271, § 202(b), 39 Stat. 756, 777-78.

23. See T. Ludlow Chrystie, *Death Taxes and Gift Taxes on Inter Vivos Transfers — Their Correlation*, 14 TAXES 716, 716 (1936).

24. SOLOMON, *supra* note 21, § 7.02, at 346.

25. *Id.*

26. *Id.* § 1.01, at 4-5; Chrystie, *supra* note 23, at 716.

27. Revenue Act of 1924, Pub. L. No. 68-176, §§ 319-324, 43 Stat. 253, 313-16.

28. Roswell Magill, *The Federal Gift Tax*, 40 COLUM. L. REV. 773, 773 (1940).

29. Revenue Act of 1924, Pub. L. No. 68-176, §§ 319, 323, 43 Stat. 253, 313-14, 316.

30. Revenue Act of 1924, Pub. L. No. 68-176, § 321(a)(1), 43 Stat. 253, 314.

31. Revenue Act of 1924, Pub. L. No. 68-176, § 321(a)(3), 43 Stat. 253, 314.

32. H.R. REP. NO. 708, 72d Cong., 1st Sess. (1932), *reprinted in* 1939-1 C.B. (Part 2) 457, 477; S. REP. NO. 665, 72d Cong., 1st Sess. (1932), *reprinted in* 1939-1 C.B. (Part 2) 496, 525.

33. Revenue Act of 1926, Pub. L. No. 69-20, § 324, 44 Stat. 9, 86.

34. Magill, *supra* note 28, at 774-75.

however, meant a return to federal deficits and increased taxes.³⁵ In 1932, the true antecedent of our current federal gift tax was enacted³⁶ as part of Congress' search for revenues.³⁷

The 1932 gift tax provided a \$50,000 lifetime exemption³⁸ and a \$5,000 per donee annual exclusion.³⁹ The tax was cumulative; taxable gifts made in earlier years would affect the rate at which taxable gifts in subsequent years would be taxed.⁴⁰ The cumulative nature of the tax was intended to impose a gift tax that approached the estate tax that would have been paid had the gift not been made.⁴¹

The gift tax was enacted to protect the progressive income tax and the estate tax.⁴² The House Ways and Means Committee and the Senate Finance Committee explained:

The gift tax will supplement both the estate tax and the income tax. It will tend to reduce the incentive to make gifts in order that distribution of future income from the donated property may be to a number of persons with the result that the taxes imposed by the higher brackets of the income tax law are avoided. It will also tend to discourage transfers for the purpose of avoiding the estate tax.⁴³

The gift tax, nonetheless, contained significant incentives for making gifts. The gift tax was separate from the estate tax; it had its own exemption and tax rates (set at three-fourths of the estate tax rates).⁴⁴ The gift tax annual exclusion had no estate tax counterpart. The gift tax, moreover, was tax-exclusive while the estate tax was tax-inclusive.⁴⁵ These factors meant that less tax would be paid if property

35. *Id.* at 775.

36. Revenue Act of 1932, Pub. L. No. 72-154, §§ 501-532, 47 Stat. 169, 245-59.

37. See Magill, *supra* note 28, at 775.

38. Revenue Act of 1932, Pub. L. No. 72-154, § 505(a)(1), 47 Stat. 169, 247.

39. Revenue Act of 1932, Pub. L. No. 72-154, § 504(b), 47 Stat. 169, 247.

40. Revenue Act of 1932, Pub. L. No. 72-154, § 502, 47 Stat. 169, 246; see H.R. REP. NO. 708, 72d Cong., 1st Sess. (1932), *reprinted in* 1939-1 C.B. (Part 2) 457, 477; S. REP. NO. 665, 72d Cong., 1st Sess. (1932), *reprinted in* 1939-1 C.B. (Part 2) 496, 525.

41. H.R. REP. NO. 708, 72d Cong., 1st Sess. (1932), *reprinted in* 1939-1 C.B. (Part 2) 457, 477; S. REP. NO. 665, 72d Cong., 1st Sess. (1932), *reprinted in* 1939-1 C.B. (Part 2) 496, 525.

42. *Dickman v. Commissioner*, 465 U.S. 330, 338 (1984) ("Our holding . . . is fully consistent with one of the major purposes of the federal gift tax statute: protection of the estate tax and the income tax."); H.R. REP. NO. 708, 72d Cong., 1st Sess. (1932), *reprinted in* 1939-1 C.B. (Part 2) 457, 477; S. REP. NO. 665, 72d Cong., 1st Sess. (1932), *reprinted in* 1939-1 C.B. (Part 2) 496, 525.

43. H.R. REP. NO. 708, 72d Cong., 1st Sess. (1932), *reprinted in* 1939-1 C.B. (Part 2) 457, 477; S. REP. NO. 665, 72d Cong., 1st Sess. (1932), *reprinted in* 1939-1 C.B. (Part 2) 496, 525.

44. Magill, *supra* note 28, at 776.

45. Harrison, *supra* note 7, at 384. ("The gift tax system is tax exclusive; that is, there is no additional gift tax on the amount used to pay the gift tax. In contrast, the estate tax is tax inclusive; in essence, there is an additional estate tax on the amount used to pay the estate tax."); PEAT & WILLBANKS, *supra* note 1, § 3.02, at 27. Any gift tax paid on gifts made within three years of the donor's death, however, must be included in the donor's gross estate for estate tax purposes. I.R.C.

were transferred during life rather than at death.⁴⁶

Congress intended to remove some of these preferences for lifetime gifting and to provide a more progressive transfer tax system⁴⁷ when it combined the gift and estate taxes into a unified transfer tax system in 1976.⁴⁸ A unified rate schedule⁴⁹ and unified credit⁵⁰ against the gift and estate taxes were enacted. Post-1976 taxable gifts are taken into account in determining the tax rate on decedents' taxable estates.⁵¹ Congress, however, did not intend to eliminate all incentives for lifetime gifting⁵² and significant incentives to make gifts remain in the transfer tax system.⁵³ One of those incentives is the annual exclusion.⁵⁴

In 1981, Congress substantially increased the amount of the unified credit⁵⁵ in order to offset the effects of inflation and to provide estate and gift tax relief to small estates.⁵⁶ Every taxpayer can now transfer property having an aggregate value of \$600,000 during lifetime or at death without incurring a gift or estate tax obligation.⁵⁷ It was estimated in 1981 that approximately one-half of one percent of decedents would be subject to federal transfer taxation after the phase-in of the unified credit increases.⁵⁸ The annual exclusion, consequently, is of primary benefit as a transfer tax avoidance device for only the wealthy.

§ 2035(c). This "gross-up" provision was intended to eliminate the incentive to make deathbed transfers in order to remove the amount of the gift tax from the transfer tax base. H.R. REP. NO. 94-1380, 94th Cong., 2d Sess. (1976), *reprinted in* 1976-3 C.B. 735, 746, 748.

46. Magill, *supra* note 28, at 776.

47. H.R. REP. NO. 94-1380, 94th Cong., 2d Sess. (1976), *reprinted in* 1976-3 C.B. 735, 745-46.

48. Tax Reform Act of 1976, Pub. L. No. 94-455, § 2001, 90 Stat. 1520, 1846-54.

49. Tax Reform Act of 1976, Pub. L. No. 94-455, § 2001(a)(1), (b)(1), 90 Stat. 1520, 1846-47, 1849; *see* H.R. REP. NO. 94-1380, 94th Cong., 2d Sess. (1976), *reprinted in* 1976-3 C.B. 735, 739.

50. Tax Reform Act of 1976, Pub. L. No. 94-455, § 2001(a)(2), (b)(2), 90 Stat. 1520, 1848, 1849.

51. I.R.C. § 2001(b).

52. H.R. REP. NO. 94-1380, 94th Cong., 2d Sess. (1976), *reprinted in* 1976-3 C.B. 735, 746.

53. PEAT & WILLBANKS, *supra* note 1, § 7.06, at 94.

54. *See* H.R. REP. NO. 94-1380, 94th Cong., 2d Sess. (1976), *reprinted in* 1976-3 C.B. 735, 746.

55. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 401, 95 Stat. 172, 299-300.

56. H.R. REP. NO. 97-201, 97th Cong., 1st Sess. (1981), *reprinted in* 1981-2 C.B. 352, 376; S. REP. NO. 97-144, 97th Cong., 1st Sess. (1981), *reprinted in* 1981-2 C.B. 412, 460.

57. *See* I.R.C. §§ 2505, 2010. (The unified credit of \$192,800 allows the tax-free transfer of property having a value of \$600,000).

58. Willard H. Pedrick, *Oh, To Die Down Under! Abolition of Death and Gift Duties in Australia*, 35 TAX LAW. 113, 113 (1981).

B. Transfers Subject to Taxation

The gift tax is a comprehensive tax⁵⁹ imposed on property transferred by gift.⁶⁰ It reaches all transactions to the extent that "property or a property right is donatively passed to or conferred upon another, regardless of the means or the device employed in its accomplishment."⁶¹ The tax, subject to certain limitations, is imposed on all property transferred by gift, regardless of whether the transfer is outright or in trust, direct or indirect, and regardless of whether the property transferred is real or personal, tangible or intangible.⁶² The Supreme Court applies the gift tax broadly to effectuate Congressional intent.⁶³

Before a transfer is subject to the gift tax, the gift must be "complete."⁶⁴ Not all irrevocable transfers are complete for gift tax purposes.⁶⁵ A gift is "complete" when the donor relinquishes dominion and control over the property, leaving him no power to change its disposition for the benefit of himself or another.⁶⁶

The gift tax applies when a transfer is made for which the transferor does not receive full and adequate consideration in money or

59. In *Dickman v. Commissioner*, 465 U.S. 330 (1984) the Court noted:

The comprehensive scope of the gift tax, reflected by its statutory language and legislative history, is analogous to that of § 61 of the Code, 26 U.S.C. § 61, which defines gross income as "all income from whatever source derived." Section 61 has long been interpreted to include all forms of income except those specifically excluded from its reach. See, e.g., *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426 (1955). Similarly, the gift tax applies to any "transfer of property by gift," Code § 2501(a)(1), "[s]ubject to the limitations contained in this chapter," Code § 2511(a). Accordingly, absent an express exclusion from its provisions, any transfer meeting the statutory requirements must be held subject to the gift tax.

Id. at 334 n.4; accord *Commissioner v. Wemyss*, 324 U.S. 303, 306 (1945); H.R. REP. NO. 708, 72d Cong., 1st Sess. (1932), reprinted in 1939-1 C.B. (Part 2) 457, 476; S. REP. NO. 665, 72d Cong., 1st Sess. (1932), reprinted in 1939-1 C.B. (Part 2) 496, 524 ("The terms 'property,' 'transfer,' 'gift,' and 'indirectly' are used in the broadest and most comprehensive sense; . . .").

60. I.R.C. § 2501(a)(1).

61. H.R. REP. NO. 708, 72d Cong., 1st Sess. (1932), reprinted in 1939-1 C.B. (Part 2) 457, 476; S. REP. NO. 665, 72d Cong., 1st Sess. (1932), reprinted in 1939-1 C.B. (Part 2) 496, 524.

62. I.R.C. § 2511(a).

63. *Dickman v. Commissioner*, 465 U.S. 330 (1984); *Commissioner v. Wemyss*, 324 U.S. 303, 306 (1945); but see Mark J. Wolff, *Dickman Confined: The Taxation of Gratuitous Transfers of Use*, 21 *STEPSON L. REV.* 509, 557 (1992) (criticizing *Dickman* and suggesting a restriction of "the overbroad language of *Dickman*").

64. See *Treas. Reg.* § 25.2511-2(b) (as amended in 1983).

65. E.g., *Estate of Sanford v. Commissioner*, 308 U.S. 39 (1939).

66. *Helvering v. Hutchings*, 312 U.S. 393, 396 (1941); *Treas. Reg.* § 25.2511-2(b) (as amended in 1983); *Rev. Rul.* 67-396, 1967-2 C.B. 351, clarified by *Rev. Rul.* 84-25, 1984-1 C.B. 191.

money's worth.⁶⁷ If such consideration is received, the taxpayer's transfer tax base is not diminished and imposing a gift tax would be inappropriate.⁶⁸ Transfers made in the ordinary course of business are considered to have been made for an adequate and full consideration in money or money's worth.⁶⁹

The Supreme Court has held that donative intent on the part of the transferor is not required for a transfer to be subject to the gift tax.⁷⁰ The tax is applied on the basis of "the objective facts of the transfer and the circumstances under which it is made, rather than on the subjective motives of the donor."⁷¹ Donative intent, however, may be considered in determining whether a transfer subject to the gift tax was made.⁷²

The gift tax does not apply to transfers in satisfaction of an individual's obligation of support.⁷³ The exclusion of such transfers is not provided in the Internal Revenue Code but has been acknowledged by Congress and the Supreme Court.⁷⁴ The rationale for the exclusion is a matter of debate.⁷⁵ It has been suggested that the exclusion is allowed on the grounds that satisfying a support obligation is the equivalent of consumption by the transferor,⁷⁶ that discharge of a legal obligation is consideration for the transfer,⁷⁷ and that such trans-

67. I.R.C. § 2512(b); see H.R. REP. NO. 708, 72d Cong., 1st Sess. (1932), reprinted in 1939-1 C.B. (Part 2) 457, 477-78; S. REP. NO. 665, 72d Cong., 1st Sess. (1932), reprinted in 1939-1 C.B. (Part 2) 496, 525.

68. See PEAT & WILLBANKS, *supra* note 1, § 4.03, at 36.

69. Treas. Reg. § 25.2512-8 (1958).

70. Commissioner v. Wemyss, 324 U.S. 303, 306 (1945); see also Treas. Reg. § 25.2511-1(g)(1) (as amended in 1986).

71. Treas. Reg. § 25.2511-1(g)(1) (as amended in 1986).

72. Heyen v. United States, 945 F.2d 359, 362 (10th Cir. 1991).

73. PEAT & WILLBANKS, *supra* note 1, § 4.04, at 37; see generally Jean T. Adams, *Reconciling Family Law with Tax Policy: Untangling the Tax Treatment of Parental Trusts*, 46 TAX L. REV. 107 (1990); David Beck & Sheldon V. Ekman, *Where Does Support End and Taxable Gift Begin?*, 23 INST. ON FED. TAX'N 1181 (1965); Milton L. Ray, *The Transfer-for-Consumption Problem: Support and the Gift Tax*, 59 OR. L. REV. 425 (1981). A basis for the obligation of support is said to lie in the public policy consideration of avoiding the necessity of state support of family members. Beck & Ekman, *supra*, at 1182.

74. Dickman v. Commissioner, 465 U.S. 330, 341 (1984) ("Our laws require parents to provide their minor offspring with the necessities and conveniences of life; questions under the [gift] tax law often arise, however, when parents provide more than the necessities, and in quantities significant enough to attract the attention of the taxing authorities."); H.R. REP. NO. 97-201, 97th Cong., 1st Sess. (1981), reprinted in 1981-2 C.B. 352, 393 ("[T]he committee does not intend to change the law that there is no gift if the person paying [sic] the medical expenses or tuition is under an obligation under local law to provide such items to the recipient.").

75. See Harry L. Gutman, *Reforming Federal Wealth Transfer Taxes After ERTA*, 69 VA. L. REV. 1183, 1241 n.168 (1983).

76. PEAT & WILLBANKS, *supra* note 1, § 4.04, at 37.

77. Adams, *supra* note 73, at 123 n.64.

fers might be exempt from taxation as "involuntary" transfers required by law.⁷⁸

Most amounts expended on behalf of persons owed support will not be subject to the gift tax because of the support obligation. But not all expenditures for such persons escape taxation.⁷⁹ The extent of a person's support obligation is a matter of local law.⁸⁰ In most states the extent of the obligation is uncertain⁸¹ and may vary depending on the obligor's "earning ability, means, situation and condition in life."⁸² Even if the extent of the obligation is determinable under local law, a question remains whether the existence and extent of the obligation is determined by local or federal law for federal gift tax purposes.⁸³

The support obligation includes the necessities of life (food, clothing, and shelter),⁸⁴ but may include much more than necessities.⁸⁵ Indeed, if the exclusion were limited to the bare necessities of life, many expenditures within the family context would constitute gifts because

78. *Id.*

79. A. James Casner, *Proposed Tax Changes and Their Effect on Estate Planning*, 3 INST. ON EST. PLAN 9-1, 9-3 (1969) ("The only expenditure for a child that is not a gift is one that relates to that which a parent is legally obligated to provide."); see *Converse v. Commissioner*, 5 T.C. 1014, 1016 (1945), *aff'd* 163 F.2d 131 (2d Cir. 1947) ("The petitioner [taxpayer] may have done more for his infant daughter than the minimum required by the law. We are unable to find from the evidence that the Commissioner erred in holding that the petitioner made a gift to the trust in the amount determined by him.").

80. Beck & Ekman, *supra* note 73, at 1184; Sue A. Wyskiver, Note, *The Federal Income Tax Consequences of the Legal Obligation of Parents to Support Children*, 47 OHIO ST. L.J. 753, 759 (1986).

81. Casner, *supra* note 79, at 9-3; Wyskiver, *supra* note 80, at 759.

82. Beck & Ekman, *supra* note 73, at 1184; see also, Wyskiver, *supra* note 80, at 760-61.

83. See Beck & Ekman, *supra* note 73, at 1195; Ray, *supra* note 73, at 429-33; but see H.R. REP. NO. 97-201, 97th Cong., 1st Sess. (1981), reprinted in 1981-2 C.B. 352, 393 ("[T]he committee does not intend to change the law that there is no gift if the person paying [sic] the medical expenses or tuition is under an obligation under local law to provide such items to the recipient.") (emphasis added).

84. Beck & Ekman, *supra* note 73, at 1184-85; Wyskiver, *supra* note 80, at 760.

85. Beck & Ekman, *supra* note 73, at 1198; Boris I. Bittker, *The \$10,000 Annual Perdonee Gift Tax Exclusion*, 44 OHIO ST. L.J. 447, 448 (1983) ("[T]he parental obligation to support minor children may encompass, under local law, a duty to recognize ceremonial occasions, such as birthdays, with appropriate items."); Wyskiver, *supra* note 80, at 760. Allan J. Parker, in *How to Avoid Fraud Penalties in Estate Planning*, 7 INST. ON EST. PLAN 13-1 (1973), recognized the problems this presents:

One of the difficulties . . . is to distinguish between what is a gift by a father to a minor child and what is simply in discharge of the father's legal obligation of support. That is, it might be a taxable gift to give an adult or even a minor daughter a \$3,000 bracelet; it certainly would not be a taxable gift for a father to give a minor daughter a bicycle or a new winter jacket, whether on the occasion of her birthday or not.

Id. at 13-3.

they exceed the amount the obligor could be required to pay.⁸⁶ But exacting a gift tax from "parents who choose to go a step beyond their legal duty in providing amenities and opportunities for their minor children would never pass muster as a matter of either policy or politics."⁸⁷

In 1981, Congress removed certain payments that have a support flavor from the reach of the gift tax by enacting I.R.C. § 2503(e).⁸⁸ Direct payments of tuition⁸⁹ to educational organizations and of medical expenses to medical care providers no longer constitute transfers for gift tax purposes.⁹⁰ The exclusion was enacted out of Congressional concern that certain payments of tuition on behalf of children who had attained the age of majority and of medical expenses on behalf of elderly relatives were subject to the gift tax under prior law.⁹¹ The exclusion, however, does not require that any relationship exist between the transferor and the beneficiary of the payments and is unlimited in amount. Removal of these transfers from the reach of the gift tax increased the value of the annual exclusion for taxpayers who previously had used that exclusion to shelter such payments from taxation.

II. THE ANNUAL EXCLUSION

A. Reasons for the Exclusion

The House Ways and Means Committee and the Senate Finance Committee gave the following reasons for the annual exclusion in 1932:

Such exemption [the annual exclusion], on the one hand, is to obviate the necessity of keeping an account of and reporting numerous small gifts, and, on

86. *Cf. Converse v. Commissioner*, 5 T.C. 1014, 1016 (1945), *aff'd* 163 F.2d 131 (2d Cir. 1947); Casner, *supra* note 79, at 9-3.

87. Adams, *supra* note 73, at 124 (footnote omitted).

88. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 441(b), 95 Stat. 172, 319-20. I.R.C. § 2503(e) currently provides:

Exclusion for certain transfers for educational expenses or medical expenses.

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

(2) Qualified transfer—For purposes of this subsection, the term "qualified transfer" means any amount paid on behalf of an individual -

(A) as tuition to an educational organization described in section 170(b)(1)(A)(ii) for the education or training of such individual, or

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

89. I.R.C. § 2503(e)(2)(A). It has been suggested that it might be wise to expand the exclusion to include all educational expenses (fees, room, and board). Joseph M. Dodge, *Redoing the Estate and Gift Taxes Along Easy-to-Value Lines*, 43 TAX L. REV. 241, 344 (1988).

90. I.R.C. § 2503(e).

91. H.R. REP. NO. 97-201, 97th Cong., 1st Sess. (1981), *reprinted in* 1981-2 C.B. 352, 393.

the other, to fix the amount sufficiently large to cover in most cases wedding and Christmas gifts and occasional gifts of relatively small amounts.⁹²

Forty-four years later the House Ways and Means Committee suggested that the annual exclusion also was intended to serve as an incentive for making lifetime transfers.⁹³

Although the first reason given for the annual exclusion suggests that gifts of small amounts need never be documented or reported, that is not the case. If the combined value of all gifts made to a donee during a calendar year exceeds the annual exclusion amount, all gifts to that donee must be reported.⁹⁴ The first \$10,000 of gifts that qualify for the annual exclusion is excluded in determining the donor's taxable gifts.⁹⁵ Gifts of future interests in property do not qualify for the annual exclusion⁹⁶ and must always be documented and reported regardless of amount.⁹⁷ Even if a taxpayer concludes that a gift tax return is not required, possible valuation issues suggest it may be prudent to document gifts below the annual exclusion amount.⁹⁸ The first reason given for the exclusion, therefore, does not justify the exclusion when taxpayers most likely to fully utilize it or make gifts in excess of the exclusion amount are considered.

The second reason given for the annual exclusion is its true justifi-

92. H.R. REP. NO. 708, 72d Cong., 1st Sess. (1932), *reprinted in* 1939-1 C.B. (Part 2) 457, 478; S. REP. NO. 665, 72d Cong., 1st Sess. (1932), *reprinted in* 1939-1 C.B. (Part 2) 496, 525-26.

93. H.R. REP. NO. 94-1380, 94th Cong., 2d Sess. (1976), *reprinted in* 1976-3 C.B. 735, 746.

94. I.R.S. Instructions for Form 709 (Revised November 1991), United States Gift (and Generation Skipping Transfer) Tax Return, provide at page 4 that "[i]f the total gifts of *present interests* to any donee are more than \$10,000 in the calendar year, then you must enter *all such gifts* that you made during the year to or on behalf of that donee."

95. I.R.C. § 2503(a),(b).

96. I.R.C. § 2503(b).

97. *See* I.R.C. § 6019.

98. The statute of limitations for assessment and collection of the gift tax does not begin to run until a gift tax return is filed. *See* I.R.C. § 6501. Even if a gift tax return is filed and the statute of limitations has expired as to the year for which the return was filed, the Internal Revenue Service is not precluded from revaluing the gift for purposes of determining the value of taxable gifts for preceding calendar years (in the computation of tax for gifts in subsequent years) unless a gift tax was assessed or paid for the prior period. I.R.C. § 2504(c). Moreover, even if the I.R.S. is precluded by § 2504(c) from revaluing gifts for gift tax purposes, that section does not prevent the I.R.S. from revaluing gifts when calculating adjusted taxable gifts for estate tax purposes under I.R.C. § 2001(b)(1)(B). *Stalcup v. United States*, 792 F. Supp. 714 (W.D. Okla. 1991); *Estate of Smith v. Commissioner*, 94 T.C. 872 (1990), *acq.* 1990-2 C.B. 1; *contra* *Boatmen's First Nat. Bank of Kansas City v. United States*, 705 F. Supp. 1407 (W.D. Mo. 1988); *see* Paul L. Caron, *Revaluation of Prior Gifts for Estate Tax Purposes After Expiration of Statute of Limitations for Year of Gift*, 67 TAXES 286 (1989) (arguing that once the statute of limitations expires for gift tax purposes the I.R.S. lacks authority to revalue gifts for estate tax purposes).

cation. Customary and occasional gifts of relatively small value should be allowed without triggering the gift tax. A tax system that exacted a tax upon the occasional transfer of property of modest value would be extremely unpopular and unwise from a policy perspective. Noncompliance would be widespread, and, unless the rate of taxation were high, enforcement efforts would not be justified by revenue that would be collected. Disrespect for the entire tax system would result, seriously undermining the voluntary compliance tax system.

If the third reason suggested for the annual exclusion is "taken seriously, it would raise the interesting question of why lifetime giving should be encouraged at the cost of transfer tax base erosion."⁹⁹ Competing considerations exist in the answer to that question:

The argument for encouraging lifetime gifts is that such transfers pass new wealth to the next generation, thus avoiding "locking in" of investments and promoting the employment of capital in riskier ventures, but there is really no empirical data to support this conclusion. Even if we accept it as true, we must ask whether the benefit outweighs the cost of a high level of annual exclusion and the unfairness inherent in allowing wealthy taxpayers yet one more benefit that is not realistically available to all taxpayers.¹⁰⁰

The more than threefold increase in the unified credit since 1981 (allowing the transfer of \$600,000 of property free of gift tax) and the tax-exclusive nature of the gift tax suggest that the exclusion cannot be justified as a necessary incentive for lifetime gifting.¹⁰¹

The annual exclusion continues to be justified on the ground that taxpayers should be allowed to make customary and occasional gifts of relatively small value without precipitating the gift tax. The amount of the annual exclusion and the type of interest that qualifies for the exclusion are important to accomplishing the exclusion's limited purpose. If the exclusion amount is too low, gifts of relatively small value will not be exempted and the exclusion will not accomplish its purpose. If the exclusion amount is too high, gifts will be encouraged as a means to avoid the estate tax and the estate tax protective function of the gift tax will be impaired. If the exclusion is not limited to the transfer of interests that possess the characteristics of customary and occasional gifts, it will be used as an estate tax avoidance device.

B. Annual Exclusion Amount

The annual exclusion was set at \$5,000 when enacted in 1932.¹⁰² In 1938, the House Ways and Means Committee, which had recommended a \$3,000 exclusion in 1932,¹⁰³ considered the \$5,000 exclusion to be unreasonably large and recommended reduction to \$3,000 "[i]n

99. Gutman, *supra* note 75, at 1244 n.175.

100. PEAT & WILLBANKS, *supra* note 1, § 7.06, at 94.

101. *Id.*

102. Revenue Act of 1932, Pub. L. No. 72-154, § 504(b), 47 Stat. 169, 247.

103. H.R. REP. NO. 708, 72d Cong., 1st Sess. (1932), reprinted in 1939-1 C.B. (Part 2)

view of the frequency with which donors are induced by the exemption to build up estates of considerable size for the members of their families. . . ."¹⁰⁴ The Senate, however, agreed only to a reduction to \$4,000¹⁰⁵ for calendar years beginning with 1939.¹⁰⁶

The House Committee again proposed reduction of the annual exclusion to \$3,000 in 1942 out of concern that the exclusion impaired the estate tax protective function of the gift tax:

Since this is an annual exclusion (not exhaustible as is the specific exemption) and is not limited to any number of donees, it is possible to distribute property of large aggregate value over a period of years, free not only of gift tax but of estate tax as well. While administrative difficulties prevent the abolition of the exclusion, your committee recommend[s] that it be reduced to \$3,000.¹⁰⁷

The Senate agreed and the reduction was made in the Revenue Act of 1942¹⁰⁸.

The annual exclusion amount remained unchanged for the next thirty-nine years. In 1981, in recognition of the reduced value of the exclusion as a result of inflation,¹⁰⁹ the annual exclusion was increased to \$10,000.¹¹⁰

C. Future Interest Limitation

Because the gift tax serves an estate tax protective function and the annual exclusion provides a limited exemption from the gift tax, the type of interest that qualifies for the exclusion is important in order that the exclusion serve its limited purpose. If all interests qualified for the exclusion, it would afford a gaping loophole through which substantial amounts could be routinely transferred in avoidance of the estate tax while denying the donee current benefits characteristic of customary and occasional gifts.

Congress recognized the need to limit the annual exclusion to a certain type of interest by allowing the exclusion only for gifts of present interests; in the words of the statute, only "[i]n the case of gifts (other than gifts of future interests in property)."¹¹¹ Gifts of future

457, 478; S. REP. NO. 665, 72d Cong., 1st Sess. (1932), *reprinted in* 1939-1 C.B. (Part 2) 496, 525.

104. H.R. REP. NO. 1860, 75th Cong., 3d Sess. (1938), *reprinted in* 1939-1 C.B. (Part 2) 728, 772.

105. Revenue Act of 1938, Pub. L. No. 75-554, § 505(a), 52 Stat. 447, 565; *see* H.R. REP. NO. 2330, 75th Cong., 3d Sess. (1938), *reprinted in* 1939-1 C.B. (Part 2) 817, 830 (conference agreement reduced exclusion to \$4,000).

106. Revenue Act of 1938, Pub. L. No. 75-554, § 505(b), 52 Stat. 447, 565.

107. H.R. REP. NO. 2333, 77th Cong., 1st Sess. (1942), *reprinted in* 1942-2 C.B. 372, 403.

108. Revenue Act of 1942, Pub. L. No. 77-753, § 454, 56 Stat. 798, 953.

109. H.R. REP. NO. 97-201, 97th Cong., 1st Sess. (1981), *reprinted in* 1981-2 C.B. 352, 393; S. REP. NO. 97-144, 97th Cong., 1st Sess. (1981), *reprinted in* 1981-2 C.B. 412, 462.

110. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 441(a), 95 Stat. 172, 319.

111. I.R.C. § 2503(b).

interests always constitute taxable gifts regardless of amount.¹¹²

The House and Senate committee reports suggest the reasons for the future interest limitation:

The exemption does not apply with respect to a gift to any donee to whom is given a future interest. The term "future interests in property" refers to any interest or estate, whether vested or contingent, limited to commence in possession or enjoyment at a future date. The exemption being available only in so far as the donees are ascertainable, the denial of the exemption in the case of gifts of future interests is dictated by the apprehended difficulty, in many instances, of determining the number of eventual donees and the value of their respective gifts.¹¹³

Although the meanings of "future interest" and "present interest" are critical to application of the annual exclusion, Congress did not define those terms in the Internal Revenue Code. Current Treasury Regulations, adapted largely from Congressional committee reports, provide guidance as to the meanings of "future interest" and "present interest":

"Future interest" is a legal term, and includes reversions, remainders, and other interests or estates, whether vested or contingent, and whether or not supported by a particular interest or estate, which are limited to commence in use, possession, or enjoyment at some future date or time. . . . An unrestricted right to the immediate use, possession, or enjoyment of property or the income from property (such as a life estate or term certain) is a present interest in property.¹¹⁴

In *United States v. Pelzer*,¹¹⁵ the Supreme Court rejected the argument that state law was determinative of what constituted a future interest for purposes of the annual exclusion and emphasized the revenue protective function of the limitation:

In the absence of any statutory definition of the phrase [future interests] we look to the purpose of the statute to ascertain what is intended. It plainly is not concerned with the varying local definitions of property interests or with the local refinements of conveyancing, and there is no reason for supposing that the extent of the granted tax exemption was intended to be given a corresponding variation. Its purpose was rather the protection of the revenue and the appropriate administration of the tax immunity provided by the statute. It is this purpose which marks the boundaries of the statutory command.¹¹⁶

The interests at issue in *Pelzer* were future interests because the donee received no current benefit.¹¹⁷

112. See I.R.C. § 2503(a), (b).

113. H.R. REP. NO. 708, 72d Cong., 1st Sess. (1932), reprinted in 1939-1 C.B. (Part 2) 457, 478; S. REP. NO. 665, 72d Cong., 1st Sess. (1932), reprinted in 1939-1 C.B. (Part 2) 496, 526.

114. Treas. Reg. § 25.2503-3(a),(b)(as amended in 1983).

115. 312 U.S. 399 (1941).

116. *Id.* at 403.

117. *Id.* at 404. The Court explained:

Here the beneficiaries had no right to the present enjoyment of the corpus or of the income and unless they survive the ten-year period they will never receive any part of either. The "use, possession, or enjoy-

In *Fondren v. Commissioner*¹¹⁸ the Supreme Court held that determination of whether an interest qualifies for the annual exclusion turns on whether the interests of the beneficiaries are limited to commencing in use, possession, or enjoyment in the future:

[I]t is not enough to bring the [annual] exclusion into force that the donee has vested rights. In addition he must have the right presently to use, possess or enjoy the property. These terms are not words of art, like "fee" in the law of seisin, . . . but connote the right to substantial present economic benefit. The question is of time, not when title vests, but when enjoyment begins. Whatever puts the barrier of a substantial period between the will of the beneficiary or donee now to enjoy what has been given him and that enjoyment makes the gift one of a future interest within the meaning of the regulation.¹¹⁹

The Court denied the exclusion for the interests at issue in *Fondren* because the donees' rights were subject to a contingency of need that might never arise.¹²⁰

A corollary to the Supreme Court's holding in *Fondren* that vesting of title is not determinative is that the mere power of the donee to dispose of the gift for value will not convert a future interest into a present interest.¹²¹ On the other hand, the inability of the donee to dispose of a gift as a result of restrictive agreements may be sufficient to result in denial of the exclusion for an outright gift.¹²²

Notwithstanding these decisions, it has been suggested that the Congressional committees' reports support the proposition that the purpose of the future interest limitation is to ensure that the identity

ment" of each donee is thus postponed to the happening of a future uncertain event. The gift thus involved the difficulties of determining the "number of eventual donees and the value of their respective gifts" which it was the purpose of the statute to avoid.

118. 324 U.S. 18 (1945).

119. *Id.* at 20-21 (citation omitted).

120. *Id.* at 24.

121. *Blasdel v. Commissioner*, 58 T.C. 1014, 1021-22 (1972), *aff'd per curiam*, 478 F.2d 226, 227 (5th Cir. 1973); *Chanin v. United States*, 393 F.2d 972, 977 (Ct. Cl. 1968); *Hay v. Commissioner*, 47 B.T.A. 247, 255 (1942); Rev. Rul. 76-360, 1976-2 C.B. 298, 298. In *Chanin* the Court of Claims explained:

If plaintiffs' position were accepted, donee exclusions would be allowed in every case in which the donee received a future interest in property, which was marketable, thus doing violence to the well recognized statutory purpose of the present statute. . . . Almost every "future interest" in property, if not subject to restrictions on alienation, confers some present benefit by virtue of the fact that the donee could dispose of it immediately. Of course, the marketability of a "future interest" may not be as great as that of a fee title to property, . . . but it cannot be doubted that the donee has the right to dispose of his "future interest." Such a remainderman-donee has a future interest within the meaning of the pertinent statute, even though his interest be unqualifiedly vested at the time of the gift . . . and even though he has an immediate right to sell, devise, or otherwise dispose of his future interest.

Id. at 977 (citations omitted).

122. Rev. Rul. 76-360, 1976-2 C.B. 298.

of the donees and the amount of their respective gifts can be determined and that the donees need not have a right to immediate use, enjoyment, or possession of the property.¹²³ If that were the case, a transfer in trust for a single beneficiary would qualify for the exclusion even though the beneficiary would not be entitled to trust income or principal for a period of years.¹²⁴ That argument, however, has been repeatedly rejected by the courts.¹²⁵ The mere fact that enjoyment is postponed is enough to make the gift one of a future interest.¹²⁶

In determining whether an interest is a present interest or a future interest, it is the interest that the donee receives that must be examined.¹²⁷ The nature of the interest of the donee,¹²⁸ as well as its value,¹²⁹ is to be determined as of the date of the gift.

Almost all outright transfers of interests in property qualify for the annual exclusion. Even transfers of certain interests that appear to postpone use or enjoyment qualify for the exclusion. The outright transfer of "contractual rights as exist in a bond, note (though bearing no interest until maturity), or in a policy of life insurance, the obligations of which are to be discharged by payments in the future" is not the transfer of a future interest.¹³⁰ Allowing the exclusion for such

-
123. Robert A. Layden, Note, *Gift Tax: The Annual Exclusion and Future Interests*, 27 NOTRE DAME L. REV. 97, 112 (1951)("[T]here is no hint of a legislative desire to penalize gifts simply because enjoyment is postponed."); Richard S. Rothberg, *Crummey Powers Enhance the Usefulness of Trusts for Minors and Life Insurance Trusts*, 17 TAX'N FOR LAW. 132, 132 (1988)(suggesting that, if the present interest requirement was merely to assure that the donee is ascertainable and not to assure the donee immediate access to the gift, estate planners "can use their ingenuity in good conscience, secure in the knowledge that no violence is done to the Congressional purpose by keeping the donees separate from their money, so long as one can figure out who the donees are.").
124. See Layden, *supra* note 123, at 98 (suggesting that for every transfer there must be at least one donee for whom the donor should be able to claim the exclusion).
125. See, e.g., *Fondren v. Commissioner*, 324 U.S. 18, 26 (1945); *Commissioner v. Glos*, 123 F. 2d 548, 550 (7th Cir. 1941); *Welch v. Paine*, 120 F.2d 141, 142 (1st Cir. 1941); *Chanin v. United States*, 393 F.2d 972, 977-78 (Ct. Cl. 1968).
126. See *Commissioner v. Disston*, 325 U.S. 442, 446 (1945); *Fondren v. Commissioner*, 324 U.S. 18, 20 (1945).
127. *Wisotzkey v. Commissioner*, 144 F.2d 632, 636 (3d Cir. 1944); *Blasdel v. Commissioner*, 58 T.C. 1014, 1018 (1972), *aff'd per curiam*, 478 F.2d 226 (5th Cir. 1973); Rev. Rul. 79-280, 1979-2 C.B. 340, 341.
128. *Commissioner v. Brandegee*, 123 F.2d 58, 61 (1st Cir. 1941).
129. *Van Den Wymelenberg v. United States*, 397 F.2d 443, 445 (7th Cir. 1968), *cert. denied*, 393 U.S. 953 (1968); *Knip v. Commissioner*, 172 F.2d 755, 757 (8th Cir. 1949).
130. Treas. Reg. § 25.2503-3(a)(as amended in 1983); see Rev. Rul. 55-408, 1955-1 C.B. 113, 114 (transfer of a life insurance policy that had no cash surrender value, but granted the donee the usual incidents of ownership, constituted the transfer of a present interest, where the donee was not restricted from exercising the legal incidents of ownership by prior endorsement or otherwise).

interests has been justified on the grounds that the donee enjoys the property to the same extent as did the donor,¹³¹ that it is not the donor but the assets themselves that cause deferral,¹³² and that the donee receives possession of the property.¹³³

The annual exclusion is available for direct transfers of present interests in property to donees.¹³⁴ This is the rule even if the donee is a minor,¹³⁵ because the statute "make[s] no distinction between gifts to minors and gifts to adults."¹³⁶ The exclusion also applies if the direct transfer is to the guardian of a minor or to a trustee who is required to hold the property as if it were the guardian of the minor.¹³⁷

Gifts in trust,¹³⁸ however, do not necessarily result in allowance of the annual exclusion.¹³⁹ A gift in trust may result in the transfer of many equitable interests to many beneficiaries. Because of the many ways in which gifts may be made in trust, no simple rule exists for determining whether such a gift is of a present or future interest.¹⁴⁰ The trust provisions and surrounding circumstances must be examined to determine qualification for the annual exclusion.¹⁴¹

Transfers in trust initially raised the question of whether the donee for annual exclusion purposes was the trust or the trust beneficiaries. The Board of Tax Appeals and several circuit courts held that the trust was the donee.¹⁴² Congress, concerned that multiple trusts for the same donee might be used to avoid the per-donee limitation of the exclusion,¹⁴³ responded by denying the exclusion for all gifts in

131. Sherman, *supra* note 10, at 608.

132. PEAT & WILLBANKS, *supra* note 1, § 7.03, at 77.

133. *Id.* § 7.03, at 80-81.

134. Helvering v. Hutchings, 312 U.S. 393, 395 (1941) ("It is not doubted that separate gifts, other than gifts of future interests, made directly to the donees without the intervention of a trustee entitle the donor under § 504(b) to one \$5,000 [annual] exclusion for each gift.").

135. Daniels v. Commissioner, 10 T.C.M. (CCH) 147, 150 (1951); Rev. Rul. 54-400, 1954-2 C.B. 319 ("An unqualified and unrestricted gift to a minor, with or without the appointment of a legal guardian, is a gift of a present interest . . .").

136. Fondren v. Commissioner, 324 U.S. 18, 28 (1945).

137. See United States v. Baker, 236 F.2d 317, 320 (4th Cir. 1956); Rev. Rul. 59-78, 1959-1 C.B. 690, 691.

138. Donors may have tax as well as non-tax reasons for making gifts in trust rather than outright. See Stephan R. Leimberg, *Section 2503(b) — Use of Trusts and the Gift Tax Exclusion*, 38 INST. ON FED. TAX'N 42-1, 42-7 to 42-8 (1980) (identifying many of the reasons for transfers in trust).

139. See, e.g., Commissioner v. Disston, 325 U.S. 442 (1945); Fondren v. Commissioner, 324 U.S. 18 (1945).

140. Commissioner v. Kempner, 126 F.2d 853, 854 (5th Cir. 1942).

141. Fondren v. Commissioner, 324 U.S. 18, 24 (1945); Commissioner v. Kempner, 126 F.2d 853, 854 (5th Cir. 1942).

142. Commissioner v. Krebs, 90 F.2d 880, 881 (3d Cir. 1937); Commissioner v. Wells, 88 F.2d 339, 341 (7th Cir. 1937) *aff'g* 34 B.T.A. 315 (1936).

143. S. REP. NO. 1567, 75th Cong., 3d Sess. (1938), *reprinted in* 1939-1 C.B. (Part 2) 779, 809.

trust beginning in 1939.¹⁴⁴ Three years later, the Supreme Court held in *Helvering v. Hutchings*¹⁴⁵ that the number of annual exclusions for transfers in trust is determined by the number of trust beneficiaries receiving gifts of present interests and not at the trust level.¹⁴⁶ In 1942 Congress removed the restriction it had imposed for gifts in trust¹⁴⁷ in response to *Hutchings*.¹⁴⁸

Transfers in trust for the benefit of minors have presented particular problems in connection with the annual exclusion.¹⁴⁹ Few donors are willing to convey property directly to minors because of their inability to manage property and reservations concerning the minor's judgment upon attaining majority. These concerns often led to transfers in trust that failed to qualify for the annual exclusion because of the future interest limitation.¹⁵⁰

In 1954, Congress responded to taxpayers' desires to make gifts in trust for minors that would qualify for the annual exclusion without creating a present interest¹⁵¹ by enacting I.R.C. § 2503(c).¹⁵² The provision was a response to the uncertainty that existed with regard to the annual exclusion and gifts in trust for minors.¹⁵³ Section 2503(c)

144. Revenue Act of 1938, Pub. L. No. 75-554, § 505, 52 Stat. 447, 565.

145. 312 U.S. 393 (1941).

146. *Id.* at 398; *accord*, *Ryerson v. United States*, 312 U.S. 405, 408 (1941); *United States v. Pelzer*, 312 U.S. 399, 401-02 (1941).

147. Revenue Act of 1942, Pub. L. No. 77-753, § 454, 56 Stat. 798, 953.

148. S. REP. NO. 1631, 77th Cong., 2d Sess. (1942), *reprinted in* 1942-2 C.B. 504, 682.

149. *See, e.g.*, *Commissioner v. Disston*, 325 U.S. 442 (1945); *Fondren v. Commissioner*, 324 U.S. 18 (1945); *Crummey v. Commissioner*, 397 F.2d 82 (9th Cir. 1968); *Stifel v. Commissioner*, 197 F.2d 107 (2d Cir. 1952); *Kieckhefer v. Commissioner*, 189 F.2d 118 (7th Cir. 1951).

150. *See, e.g.*, *Commissioner v. Disston*, 325 U.S. 442 (1945); *Fondren v. Commissioner*, 324 U.S. 18 (1945); *Stifel v. Commissioner*, 197 F.2d 107 (2d Cir. 1952).

151. *See* Norman A. Sugarman & Robert M. Brucken, *The Present Interest Trust for a Minor*, 4 REAL PROP. PROB. & TR. J. 651, 653-54 (1969).

152. Internal Revenue Code of 1954, Pub. L. No. 83-591, § 2503(c), 68A Stat. 1, 405. Section 2503(c) currently provides:

(c) Transfer For The Benefit Of Minor. — No part of a gift to an individual who has not attained the age of 21 years on the date of the transfer shall be considered a gift of a future interest in property for purposes of subsection (b) if the property and the income therefrom -

(1) may be expended by, or for the benefit of, the donee before his attaining the age of 21 years, and

(2) will to the extent not so expended -

(A) pass to the donee on his attaining the age of 21 years, and

(B) in the event the donee dies before attaining the age of 21 years, be payable to the estate of the donee or as he may appoint under a general power of appointment as defined in section 2514(c).

153. H.R. REP. NO. 1337, 83d Cong., 2d Sess. (1954), *reprinted in* 1954 U.S.C.C.A.N. 4025, 4120; S. REP. NO. 1622, 83d Cong., 2d Sess. (1954), *reprinted in* 1954 U.S.C.C.A.N. 4621, 4760.

provides an exception to the present interest requirement.¹⁵⁴ The exception, however, is available only if three requirements are satisfied. First, the property and its income must be capable of being expended by or for the benefit of the minor during minority.¹⁵⁵ Second, the property and its income must pass to the donee at age twenty-one.¹⁵⁶ Third, the property and its income must be payable to the minor's estate, or as he appoints pursuant to a general power of appointment, if the minor dies before age twenty-one.¹⁵⁷ These requirements meant that § 2503(c) was an imperfect solution in the eyes of many taxpayers,¹⁵⁸ and the search for additional ways to obtain the annual exclusion for transfers in trust for minors continued.¹⁵⁹

D. Burden of Proof

The taxpayer has the burden of proving that he is entitled to the annual exclusion.¹⁶⁰ The burden requires that the taxpayer prove the gift is of a present interest¹⁶¹ and the amount of the exclusion to which he is entitled.¹⁶² This burden is consistent with the rule that Internal Revenue Service deficiency determinations are presumed to be correct and taxpayers have the burden of proving them to be

154. Sugarman & Brucken, *supra* note 151, at 652.

155. I.R.C. § 2503(c)(1).

156. I.R.C. § 2503(c)(2)(A).

157. I.R.C. § 2503(c)(2)(B).

158. See Polisher, *Estate and Gift Tax Changes Made by the 1954 Revenue Code*, 59 DICK. L. REV. 1, 15 (1954) ("One must carefully consider, in the effort to utilize the annual exclusion, whether the cure might not be worse than the disease, in that a substantial sum of money may be paid over to the donee at an early age, when he is immature and ill-equipped to handle it").

159. In Tech. Adv. Mem. 87-27-7003 (Mar. 16, 1987), the I.R.S. acknowledged the impact of the restrictions:

Although the enactment of section 2503(c) in 1954 provided some relief, it was restricted in application. Hence, the continued tendency of estate planners to give minor beneficiaries an overriding right to demand the trust property outright, a right which became refined, with judicial approval, to a right limited in time.

Id. (citation omitted).

160. *Commissioner v. Disston*, 325 U.S. 442, 449 (1945); *Maryland National Bank v. United States*, 609 F.2d 1078, 1080 (4th Cir. 1979); *Kniep v. Commissioner*, 172 F.2d 755, 758 (8th Cir. 1949); *Commissioner v. Brandegee*, 123 F.2d 58, 62 (1st Cir. 1941); Rev. Rul. 79-280, 1975-2 C.B. 340, 341.

161. *Commissioner v. Disston*, 325 U.S. 442, 449 (1945); *Kniep v. Commissioner*, 172 F.2d 775, 758 (8th Cir. 1949); *Commissioner v. Brandegee*, 123 F.2d 58, 62 (1st Cir. 1941); Rev. Rul. 79-280, 1975-2 C.B. 340, 341; see also *Maryland National Bank v. United States*, 609 F.2d 1078, 1080 (4th Cir. 1979).

162. *Commissioner v. Disston*, 325 U.S. 442, 449 (1945); *Maryland National Bank v. United States*, 609 F.2d 1078, 1080 (4th Cir. 1979); *Kniep v. Commissioner*, 172 F.2d 775, 758 (8th Cir. 1949).

wrong.¹⁶³

The burden of proof is extremely important in annual exclusion cases. In recent years the Internal Revenue Service has argued that the annual exclusion should be denied on the basis that the donor did not intend to grant the donee a present interest,¹⁶⁴ that the transfer was illusory,¹⁶⁵ and that the transfer to one person was in substance an indirect transfer to another.¹⁶⁶ These arguments arise most often in connection with transfers in trust subject to lapsing demand powers.¹⁶⁷

These arguments invoke the substance over form doctrine¹⁶⁸ and require a facts and circumstances determination based upon the trust instrument and surrounding circumstances.¹⁶⁹ The substance over form doctrine applies to gift and estate taxes as well as income tax.¹⁷⁰ The doctrine is grounded in common sense; taxation depends not on the form chosen by the taxpayer but on the substance of the transaction.¹⁷¹ Transactions that take place among family members and create tax benefits are to be carefully scrutinized¹⁷² "in order to determine if they are in economic reality what they appear to be on their face."¹⁷³

The question in cases in which the substance over form doctrine arises is often whether there was an agreement or understanding between the donor and the donee that the donee would act in a certain

-
163. *Welch v. Helvering*, 290 U.S. 111, 115 (1933); *Muserlian v. Commissioner*, 932 F.2d 109, 112 (2d Cir. 1991); *Bernuth v. Commissioner*, 470 F.2d 710, 714 (2d Cir. 1972).
164. *E.g.*, *Estate of Cristofani v. Commissioner*, 97 T.C. 74, 83 (1991), *acq. in result*, 1992-1 C.B. 1, *action on decision*, 1992-09 (Mar. 23, 1992); Rev. Rul. 81-7, 1981-1 C.B. 474; Rev. Rul. 85-24, 1985-1 C.B. 329, 330; Tech. Adv. Mem. 90-45-002 (July 27, 1990); Tech. Adv. Mem. 87-27-003 (Mar. 16, 1987).
165. *E.g.*, *Estate of Cristofani v. Commissioner*, 97 T.C. 74, 83 (1991), *acq. in result*, 1992-1 C.B. 1, *action on decision*, 1992-09 (Mar. 23, 1992); Rev. Rul. 81-7, 1981-1 C.B. 474; Rev. Rul. 85-24, 1985-1 C.B. 329, 330.
166. *E.g.*, *Heyen v. United States*, 945 F.2d 359, 363 (10th Cir. 1991); Rev. Rul. 85-24, 1985-1 C.B. 329, 330; Tech. Adv. Mem. 91-41-008 (June 24, 1991); Tech. Adv. Mem. 90-45-002 (July 27, 1990); Tech. Adv. Mem. 87-27-003 (Mar. 16, 1987).
167. *E.g.*, *Estate of Cristofani v. Commissioner*, 97 T.C. 74, 83 (1991), *acq. in result*, 1992-1 C.B. 1, *action on decision*, 1992-09 (Mar. 23, 1992); Rev. Rul. 81-7, 1981-1 C.B. 474; Rev. Rul. 85-24, 1985-1 C.B. 329, 330; Tech. Adv. Mem. 90-45-002 (July 27, 1990); Tech. Adv. Mem. 87-27-003 (Mar. 16, 1987).
168. *See note 14 supra*.
169. *Fondren v. Commissioner*, 324 U.S. 18, 24 (1945); *Commissioner v. Kempner*, 126 F.2d 853, 854 (5th Cir. 1942).
170. *Heyen v. United States*, 945 F.2d 359, 363 (10th Cir. 1991); *see Chanin v. United States*, 393 F.2d 972, 978-79 (Ct. Cl. 1968); *Estate of Maxwell v. Commissioner*, 98 T.C. 594 (1992); *Furst v. Commissioner*, 21 T.C.M. (CCH) 1169, 1172-73 (1962).
171. *See note 14 supra*.
172. *Commissioner v. Culbertson*, 337 U.S. 733, 746 (1949); *Muserlian v. Commissioner*, 932 F.2d 109, 112 (2d Cir. 1991); *Estate of Reynolds v. Commissioner*, 55 T.C. 172, 201 (1970); *Gibbon v. Commissioner*, 19 T.C. 78, 84 (1952).
173. *Gibbon v. Commissioner*, 19 T.C. 78, 84 (1952).

way.¹⁷⁴ Must the Commissioner prove the existence of an agreement or understanding, or must the taxpayer disprove its existence? In the absence of proof, should the finder of fact be allowed to infer an agreement or understanding where the facts and circumstances do not pass a "smell test"? Common sense should not be disregarded in deciding these questions; agreements are often unnecessary among family members who are aware of the donor's purpose.¹⁷⁵

In the estate tax area, similar burden of proof issues arise in the application of § 2036(a)(1).¹⁷⁶ If a parent transfers his residence to his children, but continues sole occupancy of the property until death, the issue is whether the parent retained possession or enjoyment of the transferred property.¹⁷⁷ If he did, the value of the property will be included in the parent's gross estate for estate tax purposes.¹⁷⁸ The transfer of title is not conclusive; if it were, form would prevail over substance and the estate tax could easily be avoided.¹⁷⁹

Courts use the substance over form doctrine when applying § 2036(a)(1) to determine the estate tax result.¹⁸⁰ An express or implied understanding between the parties that the parent will have use of the property for life is sufficient under § 2036(a)(1).¹⁸¹ The Tax

174. *E.g.* Estate of Cristofani v. Commissioner, 97 T.C. 74, 83 (1991), *acq. in result*, 1992-1 C.B. 1, *action on decision*, 1992-09 (Mar. 23, 1992); Tech. Adv. Mem. 91-41-008 (June 24, 1991); Tech. Adv. Mem. 90-45-002 (July 27, 1990); *see* Heyen v. United States, 945 F.2d 359, 361 (10th Cir. 1991).
175. Kent Mason, *An Analysis of Crummey and the Annual Exclusion*, 65 MARQ. L. REV. 573, 593 n.63 (1982); *see also*, Nicholas A.J. Vlietstra, Note, Estate of Cristofani v. Commissioner: *The Expanded Potential of Crummey Powers for Transfer Tax Avoidance*, 45 TAX LAW. 583, 590 (1992) ("Especially in a situation where the trustor has created a trust to benefit his family, the donee's understanding that his benefactor intends the withdrawal powers to remain unused acts as the functional equivalent of an agreement to limit present enjoyment.").
176. *E.g.*, Estate of Maxwell v. Commissioner, 98 T.C. 594 (1992); Estate of Rapelje v. Commissioner, 73 T.C. 82, 86 (1979); Estate of Linderme v. Commissioner, 52 T.C. 305, 309 (1969).
177. Guynn v. United States, 437 F.2d 1148, 1150 (4th Cir. 1971); Estate of Maxwell v. Commissioner, 98 T.C. 594 (1992); Estate of Rapelje v. Commissioner, 73 T.C. 82, 85-86 (1979); Estate of Linderme v. Commissioner, 52 T.C. 305, 307 (1969).
178. I.R.C. § 2036(a)(1); Guynn v. United States, 437 F.2d 1148, 1149 (4th Cir. 1971); Estate of Maxwell v. Commissioner, 98 T.C. 594 (1992); Estate of Rapelje v. Commissioner, 73 T.C. 82, 85-86 (1979); Estate of Linderme v. Commissioner, 52 T.C. 305, 307 (1969).
179. Guynn v. United States, 437 F.2d 1148, 1150 (4th Cir. 1971); Estate of Maxwell v. Commissioner, 98 T.C. No. 39 (May 13, 1992); Estate of Rapelje v. Commissioner, 73 T.C. 82, 85-86 (1979); Estate of Linderme v. Commissioner, 52 T.C. 305, 309 (1969).
180. Estate of Maxwell v. Commissioner, 98 T.C. No. 594 (1992); Estate of Rapelje v. Commissioner, 73 T.C. 82, 85-86 (1979); Estate of Linderme v. Commissioner, 52 T.C. 305, 309 (1969).
181. Guynn v. United States, 437 F.2d 1148, 1150 (4th Cir. 1971); Estate of Maxwell v. Commissioner, 98 T.C. 594 (1992); Estate of Rapelje v. Commissioner, 73 T.C. 82, 86 (1979); Treas. Reg. § 20.2036-1(a) (as amended in 1960) ("An interest or right is

Court has held that the burden is on the taxpayer "to disprove the existence of any implied agreement or understanding, and that burden is particularly onerous when intrafamily arrangements are involved."¹⁸² In determining whether there was an implied understanding, courts consider all facts and circumstances surrounding the transfer and subsequent use.¹⁸³

Courts should take a similar approach in deciding annual exclusion cases. Courts should use the substance over form doctrine cognizant of the gift tax's estate tax protective purpose and of the limited exemption intended by Congress when it enacted the annual exclusion. The exclusion, as a matter of legislative grace, should be strictly construed, and transactions among family members should be carefully scrutinized. The Commissioner should not be required to prove the existence of an agreement or understanding between the donor and donee. The existence of an agreement or understanding should be inferred where the facts and circumstances suggest the substance of the transaction is not reflected in its form. The burden of proof should be on the taxpayer to disprove the existence of an implied agreement or understanding. If the courts approached annual exclusion cases from this perspective, the limited exclusion intended by Congress would be fully allowed and current abuses would be checked.

III. AVAILABILITY OF THE ANNUAL EXCLUSION FOR CERTAIN TRANSFERS

A three-part test must be satisfied in order to obtain the annual exclusion: First, the donee must receive the immediate use, enjoyment, or possession of the property (a present interest in the property).¹⁸⁴ Second, the identity of the donee must be determinable.¹⁸⁵

reated as having been retained or reserved if at the time of the transfer there was an understanding, express, or implied, that the interest or right would later be conferred."); Rev. Rul. 78-409, 1978-2 C.B. 234; Rev. Rul. 70-155, 1970-1 C.B. 189.

182. Estate of Rapelje v. Commissioner, 73 T.C. 82, 86 (1979); *see also* Estate of Maxwell v. Commissioner, 98 T.C. 594 (1992); Estate of Linderme v. Commissioner, 52 T.C. 305, 309 (1969); *but see* Mason, *supra* note 175, at 595 n.66 (suggesting that the I.R.S. has the burden of proving the existence of an understanding).
183. Gynn v. United States, 437 F.2d 1148, 1150 (4th Cir. 1971); Estate of Maxwell v. Commissioner, 98 T.C. 594 (1992); Estate of Rapelje v. Commissioner, 73 T.C. 82, 86 (1979); Estate of Linderme v. Commissioner, 52 T.C. 305, 307 (1969); Rev. Rul. 78-409, 1978-2 C.B. 234.
184. I.R.C. § 2503(b); Commissioner v. Disston, 325 U.S. 442, 445 (1945); Fondren v. Commissioner, 324 U.S. 18, 20 (1945).
185. I.R.C. § 2503(b)(the exclusion is provided on a per-donee basis); Heyen v. United States, 945 F.2d 359, 363 (10th Cir. 1991)("Actual donees of gift property must be identified, despite the naming by a donor of a beneficiary." (citations omitted)); *see also* Bittker, *supra* note 85, at 449 (identifying one of the principal issues that arise in connection with the annual exclusion as identification of the donee).

Third, the value of the gift must be ascertainable at the time of the gift.¹⁸⁶ Common sense application of these requirements would limit the exclusion to the narrow exemption intended by Congress and needed to achieve the gift tax's estate tax protective purpose.

A. Income Interests

In *Commissioner v. Brandegee*,¹⁸⁷ the First Circuit held that "the gift of an immediate life interest in income is to be regarded as a present interest"¹⁸⁸ for purposes of the annual exclusion. The court concluded that in "ordinary usage" a life tenant under a trust, having the right to the immediate enjoyment of the income, is considered to have a present interest even though possession of the corpus is postponed or withheld.¹⁸⁹ A Treasury Regulation in which the annual exclusion amount was subtracted from the value of a life estate in reaching net gifts was cited by the court; it found "by necessary implication" that a mere life estate was a present interest.¹⁹⁰ The court did not further justify its holding.

Although the court in *Brandegee* held that an income interest was a present interest, it noted that the ability of a trustee to make discretionary distributions of income would not create a present interest.¹⁹¹ The exclusion would be denied even though the trustee exercised its discretion and distributed trust income.¹⁹² The nature of the donee's interest is to be determined as of the date of the gift, not by what the trustee subsequently does in the exercise of its discretion.¹⁹³ Denial of the exclusion where the trustee has discretion over income distributions is required because neither the identity of the donee nor the value of the interest transferred to any donee can be determined at the time of the transfer.¹⁹⁴

One year later a federal district court in *Charles v. Hassett*¹⁹⁵ had to determine whether the annual exclusion would be allowed for a transfer under which a donee was entitled to trust income immedi-

186. *Stark v. United States*, 477 F.2d 131, 132 n.1 (8th Cir. 1973); *Van Den Wymelenberg v. United States*, 397 F.2d 443, 445 (7th Cir. 1968), *cert. denied*, 393 U.S. 953 (1968); *Knip v. Commissioner*, 172 F.2d 755, 757 (8th Cir. 1949); *see also* *Sherman*, *supra* note 10, at 588-89 ("[I]t is necessary to determine the value of what each donee receives because the exclusion is limited to the lesser of \$10,000 or the value of what the donee receives." (footnote omitted)).

187. 123 F.2d 58 (1st Cir. 1941).

188. *Id.* at 62.

189. *Id.*

190. *Id.*

191. *Id.* at 61.

192. *Id.*

193. *Id.*

194. *See Helvering v. Blair*, 121 F.2d 945, 947 (2d Cir. 1941).

195. 43 F. Supp. 432 (D. Mass. 1942).

ately and to trust principal in equal one-third shares when he attained the ages of twenty-five, thirty, and thirty-five.¹⁹⁶ The court considered several possible solutions to the issues and discussed at length the question of whether an income interest should be considered a present interest:

The fourth solution, starting from the same premises, but putting more emphasis on the uncertainty, and especially the remoteness in time, which underlie the payments of both income and of corpus, regards both interests as "future interests" and hence not excludible from the gift tax.

A priori, there is much to be said for the fourth view. Congress, though it did not speak clearly, may have meant to exclude from the gift tax only those gifts which the donee received and was free to dispose of during the taxable year. This would allow for the customary anniversary, holiday and like gifts without making it possible for the donor to escape taxation on the equivalent of a testamentary trust. Moreover, it is startling to a layman to be told that for tax purposes he has a "present interest" when all the gift is to be paid in the future and is to be paid only if he lives. And his surprise is not lessened when, as in the case at bar, he is told that although his interest has an appraised value, it has no market value because the donor, by a spendthrift trust, has made the gift unassignable and beyond the reach of creditors.¹⁹⁷

The court, nonetheless, concluded that it was bound by precedent and allowed the annual exclusion for the income interest.¹⁹⁸

In 1954, Congress implicitly recognized income interests as present interests when it amended § 2503(b).¹⁹⁹ The amendment provided that the possibility that a present interest (*i.e.* an income interest) might be diminished by the exercise of a power to distribute principal to the income beneficiary is to be disregarded in determining whether the gift of the income interest is a future interest.²⁰⁰ The change was intended to overrule several court decisions in which the annual exclusion had been denied for income interests on the ground that the value of the interests could not be determined if the trustee could distribute principal to the income beneficiary.²⁰¹ Before the amendment, the result of "giving an income beneficiary an *additional* right—namely, a right potentially to enjoy the principal—turned what would otherwise have been a present interest into a future interest."²⁰² But if principal can be distributed among a number of income beneficiaries or to someone other than the income beneficiary, the value of the income interest will be valued as if maximum principal distributions

196. *Id.* at 433.

197. *Id.* at 434 (citation omitted).

198. *Id.* at 434-35 (citing *Commissioner v. Brandegee*, 123 F.2d 58 (1st Cir. 1941)).

199. Internal Revenue Code of 1954, Pub. L. No. 83-591, § 2503(b), 68A Stat. 1, 404-05; see S. REP. NO. 1622, 83d Cong., 2d Sess. (1954), reprinted in 1954 U.S.C.C.A.N. 4621, 5122-23.

200. I.R.C. § 2503(b); Polisher, *supra* note 158, at 14.

201. S. REP. NO. 1622, 83d Cong., 2d Sess. (1954), reprinted in 1954 U.S.C.C.A.N. 4621, 5122-23; see also *Evans v. Commissioner*, 198 F.2d 435, 437 (3d Cir. 1952); Rev. Rul. 54-92, 1954-1 C.B. 207, declared obsolete by, Rev. Rul. 82-127, 1982-1 C.B. 215.

202. Sherman, *supra* note 10, at 643.

will be made.²⁰³

The rules regarding allowance of the annual exclusion for income interests have been refined by case law. Brief postponement of the right to income will result in denial of the exclusion,²⁰⁴ while delays in income distributions that result from ordinary administrative provisions will not.²⁰⁵ The annual exclusion will be allowed even though the trust contains a valid spendthrift provision, precluding voluntary alienation of the income interest.²⁰⁶ The annual exclusion will not be allowed, however, if the trust assets will not generate income for distribution to beneficiaries entitled to income.²⁰⁷

Allowance of the annual exclusion for gifts of income interests is firmly established. Congress implicitly recognized that income interests are present interests in 1954,²⁰⁸ the Supreme Court apparently approved the exclusion for income interests in *Fondren*,²⁰⁹ current Treasury Regulations specifically allow the exclusion for immediate and unrestricted income interests,²¹⁰ and the Internal Revenue Service has long acknowledged availability of the exclusion for such interests.²¹¹

Notwithstanding current law, should the annual exclusion be al-

203. See *Kniep v. Commissioner*, 172 F.2d 755, 757-58 (8th Cir. 1949).

204. *Hessenbruch v. Commissioner*, 178 F.2d 785, 787 (3d Cir. 1950)(three-month postponement made gift a future interest).

205. *Fisher v. Commissioner*, 132 F.2d 383, 386 (9th Cir. 1942)(annual distribution); *Commissioner v. Lowden*, 131 F.2d 127, 128 (7th Cir. 1942)(annual distribution did not result in denial of annual exclusion where the purpose of the annual payment was "not to postpone vesting and enjoyment of income until a future date, but to provide a convenient distributive procedure."); *Commissioner v. Kempner*, 126 F.2d 853, 854 (5th Cir. 1942)(distribution "as soon as reasonably practicable"). The I.R.S. acknowledged this in Rev. Rul. 83-108, 1983-2 C.B. 168:

In order for an unrestricted income interest to qualify for an annual exclusion under section 2503(b) of the Code, there is no requirement that the income be distributed to the income beneficiary as it is earned. Rather, as a matter of convenience in administering the trust, the income need be distributed only annually or more often.

Id. (citations omitted).

206. *Fisher v. Commissioner*, 132 F.2d 383, 386 (9th Cir. 1942); *Charles v. Hassett*, 43 F. Supp. 432, 434 (D. Mass. 1942); Rev. Rul. 54-344, 1954-2 C.B. 319.

207. *Maryland National Bank v. United States*, 609 F.2d 1078, 1080 (4th Cir. 1979)(annual exclusion was denied where taxpayer failed to prove that partnership produced any income or that there would be any income in the foreseeable future); *Calder v. Commissioner*, 85 T.C. 713, 728 (1985)(annual exclusion was denied where trust corpus consisted of artwork and there was no showing that the trust assets would generate income for distribution).

208. See note 199 *supra*.

209. Bittker, *supra* note 85, at 453.

210. Treas. Reg. § 25.2503-3(b)(as amended in 1983).

211. See Rev. Rul. 83-108, 1983-2 C.B. 168; Rev. Rul. 75-506, 1975-2 C.B. 375, 376; Rev. Rul. 54-344, 1954-2 C.B. 319.

lowed for the transfer of an income interest?²¹² Does the transfer of an income interest satisfy the three-part annual exclusion test?

The first requirement of the test is not satisfied. The gift of an income interest is necessarily the gift of a right to future benefits. The true subject of the gift (future income, not the right to income) does not exist at the time of the transfer. Time must pass in order for the right to result in economic benefit to the donee. Receipt of economic benefit, moreover, is contingent on the donee's survivorship. The donee might die the day after the interest is created and, in fact, receive nothing. Economic benefit can be realized only by living and receiving the income or through sale of the interest. Marketability of property transferred by gift, however, is not the test for annual exclusion purposes.²¹³ Although the transfer of the "right" to enjoyment of income is immediate, enjoyment is as much in futuro as is enjoyment of principal to be distributed in the future. Common sense suggests the transfer of the right to something not in existence on the date of transfer is necessarily the transfer of a future interest.

The second requirement of the test is not satisfied either. The donee of the income interest for which the annual exclusion is claimed cannot be ascertained at the time of the transfer. This is not to suggest that the identity of the person entitled to income under the trust or other conveyance is not ascertainable, but rather that it cannot be known at the time the interest is created who, in fact, will receive the income. If A is given the right to trust income for his life and B is given a vested remainder interest, the identity of the donees of the beneficial interests can be determined. But whether A or B will receive the income for which the annual exclusion is claimed cannot be determined on the date of transfer. If A dies the day after the interests are created, the income for which the annual exclusion was claimed will shift to B, who comes into possession. The exclusion will have been claimed for a gift to A which was, in fact, received by B. Mortality tables and life expectancies should not be allowed to substi-

212. Sherman, *supra* note 10, advocated denial of the annual exclusion for income interests:

Such gifts [where the donee receives less than full legal and equitable title] cannot be regarded as the kind of routine gifts Congress sought to exclude from the transfer tax base. Thus, income interests under such trusts would no longer qualify for the annual exclusion under the proposal, even if the income was to begin immediately and the right to it was unconditional.

Id. at 666-67; see also Bittker, *supra* note 85, at 453 (suggesting that "If pushed to a drily [sic] logical extreme" the rationale of *Pelzer* would deny the exclusion for income interests (at least as to amounts paid in future years) "since enjoyment of the income is postponed until it is earned by the trust and distributed to the donee.").

213. See note 121 *supra*.

tute for the certainty required to obtain the per-donee annual exclusion.

Finally, the transfer of an income interest fails under the third part of the annual exclusion test for two reasons. First, the value of the gift of income that the donee will receive cannot be determined at the time of the gift. Although the court in *Commissioner v. Lowden*²¹⁴ allowed the annual exclusion for the transfer of an income interest, it recognized that the value of income interests cannot be determined with certainty:

Until the year is ended, there is no way of ascertaining accurately just how much each beneficiary will receive. But if mere inability to forecast definitely the actual income from investments were the sole criterion of whether an interest is future, all present gifts of income accruing in the future could be classified as nothing other than future even though the right of enjoyment is immediate. Rents, dividends, indeed, practically all kinds of income are subject to lapse, change and fluctuation.²¹⁵

Valuation uncertainty is allowed to be resolved by reference to Treasury Department valuation tables²¹⁶ where there is proof that income will be received by the beneficiary.²¹⁷ While "the United States is in business with enough different taxpayers so that the law of averages has ample opportunity to work,"²¹⁸ the taxpayer should not be held to have satisfied his burden of proving the value of a present interest through use of the tables.

The second reason income interests fail to satisfy the third requirement is attributable to the lapsing nature of income interests. Even if future income were determinable with certainty, the identity of the recipient of that income cannot be determined upon creation of the income interest. If the income beneficiary dies the day after the interest is created, the income for which the annual exclusion was claimed will shift to the remainderman who comes into possession. If the donee received a term certain, his estate or heirs would receive the income. Actuarial assumptions should not be used to substitute for the certainty required to obtain the per-donee annual exclusion.

214. 131 F.2d 127 (7th Cir. 1942).

215. *Id.* at 128. The court concluded that uncertainty of amount must co-exist with restrictions upon or postponement of immediate use and enjoyment in order to result in denial of the exclusion.

216. See Treas. Reg. § 25.2512-5(f) (as amended in 1984); see also Rev. Rul. 80-80, 1980-1 C.B. 194, 195 (the tables must be used unless the individual who is to serve as the measuring life "is known to have been afflicted, at the time of transfer, with an incurable physical condition that is in such an advanced stage that death is clearly imminent.")

217. *Maryland National Bank v. United States*, 609 F.2d 1078, 1081 (4th Cir. 1979) ("The tables are appropriate only when there is proof that some income will be received by the trust beneficiaries. . . . The tables are designed to calculate the value of a present interest, not create it."); see also *Stark v. United States*, 477 F.2d 131, 132-33 (8th Cir. 1973).

218. *Gelb v. Commissioner*, 298 F.2d 544, 552 (2d Cir. 1962).

B. Indirect Outright Transfers

The annual exclusion amount is limited on a per-donee basis.²¹⁹ Taxpayers should not be allowed to avoid the per-donee limitation by reciprocal transfers (transfers to several transferees as part of a transaction in which another transferor makes compensatory transfers) or transfers through intermediaries (transfers to one person who, pursuant to an understanding or agreement, transfers the property to taxpayer's intended donee).

1. Reciprocal Gifts

In *Furst v. Commissioner*²²⁰ the taxpayer was one of three related donors who transferred shares of stock to members of the three donors' family groups.²²¹ The property transferred to each family member had a value slightly less than \$6,000, the amount that could be transferred free of gift tax through the combined operation of § 2503(b)(the annual exclusion) and § 2513 (spousal gift-splitting).²²² Each family group received the same number of shares from the other two donors as were transferred by the taxpayer.²²³ Furst and the other donors denied the existence of a prior agreement regarding the transfers, but admitted that there was, or might have been, some talk between the transferors before the transfers were made.²²⁴

The Tax Court held that taxpayer's purported transfers to the other donors' family members were not, in substance, gifts to such individuals, but were gifts to his own children:

Respondent [Commissioner] is right. Such simultaneous, circuitous transfers of identical property (stock) constituted gifts by the transferors to members of their own families, of all of the stock they transferred. It is of no significance under the gift tax statute that each petitioner accomplished the gifts of stock to members of his or her immediate family by a simultaneous round-about series of cross-transfers. The taxing statute looks at the realities. Such devious reciprocal transfers as are here present are singularly unavailing to manufacture exclusions under a taxing statute that reaches gifts "direct or indirect."²²⁵

The taxpayer was the real donor of the stock that the members of his immediate family received and his annual exclusions were limited by the number of recipients in his immediate family.²²⁶

The court, unable to find any cases involving cross-gifts, relied

219. I.R.C. § 2503(b).

220. 21 T.C.M. (CCH) 1169 (1962).

221. *Id.* at 1170.

222. *Id.*

223. *Id.* at 1171.

224. *Id.* at 1172.

225. *Id.*

226. *Id.*

upon the reciprocal trust doctrine to support its decision.²²⁷ Under that doctrine settlors who simultaneously create trusts with the same provisions and of identical property for the benefit of each other will be considered the settlor of the trust that is in form created by the other.²²⁸ In *Estate of Bischoff v. Commissioner*,²²⁹ decided after *Furst*, the court held that the purpose of the reciprocal trust "doctrine is merely to identify the transferor of property."²³⁰ *Furst* anticipated that holding and disregarded the form of the transfers in favor of their substance in determining the identities of the donor and donee.

*Schultz v. United States*²³¹ also presented a reciprocal gift pattern. In 1965, John A. Schultz gave an equal number of shares of stock in a closely held corporation to each of his three children and to each of his brother's three children.²³² On the same day Schultz's brother made gifts of the same number of shares of the same corporation to each of his children and to each of taxpayer's children.²³³ Similar reciprocal transfers were made in 1966 and in 1967.²³⁴ Schultz claimed the annual exclusion for the transfers to his brother's children.²³⁵ The district court relied upon the reciprocal trust doctrine and directed a verdict for the government, disallowing the exclusion for those transfers.²³⁶ The Fourth Circuit affirmed.²³⁷ It held that "a reasonable jury could have concluded only that the taxpayer intended to benefit his children, rather than those of his brother, by the gifts in question."²³⁸ The court did not reach the issue of whether the reciprocal trust doctrine applied to indirect gifts.²³⁹

2. Gifts Through Intermediaries

In *Heyen v. United States*, Jennie Owen transferred shares of stock valued at less than the annual exclusion amount to twenty-nine individuals.²⁴⁰ All but two of the twenty-nine recipients endorsed the stock certificates in blank, and the shares were reissued to members of

227. *Id.*

228. *Id.*

229. 69 T.C. 32 (1977).

230. *Id.* at 46.

231. 493 F.2d 1225 (4th Cir. 1974).

232. *Id.*

233. *Id.*

234. *Id.*

235. *Id.*

236. *Id.* at 1225-26.

237. *Id.* at 1226.

238. *Id.*

239. *Id.*; see also Tech. Adv. Mem. 87-17-003 (Jan. 17, 1987)(the I.R.S. relied upon *Schultz*, the substance over form doctrine, and the reciprocal trust doctrine in denying the annual exclusion in a cross-gift situation).

240. *Heyen v. United States*, 945 F.2d 359, 361 (10th Cir. 1991).

Owen's family.²⁴¹ The twenty-nine "donees" either did not know they were receiving a gift or had agreed before receipt that they would endorse the stock certificates in order that the stock could be reissued to members of Owen's family.²⁴² It was Owen's wish to avoid gift taxes.²⁴³ Owen died nine months after the transfers.²⁴⁴ Owen's executor filed a gift tax return but did not report the twenty-nine stock transfers.²⁴⁵ It was the executor's position that Owen had made separate gifts to the intermediate recipients, who voluntarily permitted re-transfer to decedent's family members.²⁴⁶

The Tenth Circuit held that Owen had merely used the intermediary transferees to create gift tax exclusions in order to avoid paying gift taxes on indirect gifts to family members.²⁴⁷ The court held that the substance over form doctrine applies to the gift tax and that "[d]ecedent's initial transfer of stock to nonfamily members is not determinative."²⁴⁸ Section 2511(a) required consideration of whether decedent had made indirect transfers.²⁴⁹ The actual donees of the gifts had to be identified despite the naming of beneficiaries by the donor.²⁵⁰ The annual exclusion was allowed for the transfers to the two individuals who had kept the stock because "the end result was not the same,"²⁵¹ but was denied for all other transfers.²⁵² The court upheld the jury's finding that the executor had intended to evade gift taxes by filing a fraudulent gift tax return.²⁵³

Section 2511(a) specifically provides that the gift tax applies to indirect transfers. Treasury Regulations contain the following examples of indirect gifts:

(2) The transfer of property to B if there is imposed upon B the obligation of paying a commensurate annuity to C is a gift to C.

(3) The payment of money or the transfer of property to B in consideration of B's promise to render a service to C is a gift to C, or to both B and C, depending on whether the service is or is not an adequate and full consideration in money or money's worth for that which is received by B.²⁵⁴

Indirect transfers in reciprocal gifts and gifts through intermediary

241. *Id.*

242. *Id.*

243. *Id.*

244. *Id.*

245. *Id.*

246. *Id.* at 362.

247. *Id.* at 363.

248. *Id.* at 362-63.

249. *Id.* at 363.

250. *Id.*

251. *Id.*

252. *Id.*

253. *Id.* at 364-65.

254. Treas. Reg. § 25.2511-1(h)(2),(3)(as amended in 1986).

situations are in substance conditional transfers;²⁵⁵ the transfers are made on the condition (agreement or understanding) that a compensatory gift will be made in the reciprocal gift situation and that the intermediary recipient will transfer the property to the intended donee in the intermediary gift situation. The trial court in *Heyen* recognized this when it stated that the donor "may have never parted with ownership and control of the stock during the first transfer."²⁵⁶ Dominion and control were relinquished, and the gift became complete when the agent reconveyed to the intended family donee.²⁵⁷

The second requirement under the three-part annual exclusion test is identification of the donee of the present interest. These cases stand for the principle that the substance over form doctrine requires determination of the actual donor and donee regardless of the form employed. The exclusion's per-donee limitation should be enforced; the exclusion should not be allowed for a transfer to one person which is in fact a transfer to another. None of the courts in these cases discussed the burden of proof or required that the Commissioner prove the existence of an agreement or understanding between the parties before an indirect gift was found. The courts were justified in concluding that the transfers were part of an integrated transaction undertaken to obtain multiple annual exclusions for gifts to a limited number of donees.

C. Nonlapsing Demand Powers

John W. Kieckhefer transferred property to a trust for his minor grandchild in 1944.²⁵⁸ The trustee could distribute income and principal to or on behalf of the grandchild as the trustee determined to be necessary for the grandchild's education, comfort, and support.²⁵⁹ Any income not required for such purposes was to be accumulated.²⁶⁰ Accumulated income and principal were to be distributed to the

255. *Cf. Guaranty Trust Co. v. Commissioner*, 98 F.2d 62, 65-66 (2d Cir. 1938)(gifts were not made by husband who transferred funds to wife on condition that she create a trust that would lend the funds to husband); *accord Johnson v. Commissioner*, 86 F.2d 710, 712-13 (2d Cir. 1936).

256. *Heyen v. United States*, 731 F. Supp. 1488, 1493 (D. Kan. 1990), *aff'd*, 945 F.2d 359 (10th Cir. 1991).

257. *See* Treas. Reg. § 25.2511-2(h)(as amended in 1983). The second sentence of the regulation provides:

If the donor delivers the [properly indorsed] stock certificate to his bank or broker as his agent, or to the issuing corporation or its transfer agent, for transfer into the name of the donee, the gift is completed on the date the stock is transferred on the books of the corporation.

Id.

258. *Kieckhefer v. Commissioner*, 189 F.2d 118, 119 (7th Cir. 1951).

259. *Id.*

260. *Id.*

grandchild at age twenty-one.²⁶¹ If the grandchild died before age twenty-one, the accumulated income and principal would be distributed to the grandchild's estate.²⁶² The trust granted the grandchild or his legally appointed guardian a nonlapsing power to demand distribution or termination of the trust.²⁶³ But no guardian had been appointed.²⁶⁴

The trustee in *Kieckhefer* was "required 'at any time' to pay the trust estate to the minor beneficiary upon demand made as provided."²⁶⁵ *Kieckhefer* required the court to determine whether the annual exclusion would be allowed for the transfer of property subject to a minor donee's nonlapsing general power of appointment, a question of first impression.²⁶⁶

The Seventh Circuit assumed that the annual exclusion would have been allowed if the trust beneficiary had been an adult.²⁶⁷ An adult beneficiary "could immediately have made a demand upon the trustee and have received the trust property."²⁶⁸ The court found that the restrictions on the gift "if they exist, are the result solely of the disability of the beneficiary due to the fact that he is a minor."²⁶⁹ Cases in which the annual exclusion had been denied because of donor-imposed restrictions were distinguished.²⁷⁰ The court held that restrictions imposed by law due to the beneficiary's minority did not transform what would otherwise be a gift of a present interest into one of a future interest.²⁷¹

The Seventh Circuit relied upon *Fondren* and focused on the donee's right to enjoy the property, rather than on his actual enjoyment:

It is not, however, the use, possession, or enjoyment by the beneficiary which marks the dividing line between a present and a future interest, but it is the right conferred upon the beneficiary to such use, possession or enjoyment. As was said in the *Fondren* case ". . . it is not enough to bring the exclusion into force that the donee has vested rights. In addition he must have the right presently to use, possess, or enjoy the property."²⁷²

The court allowed the annual exclusion for the transfers subject to the nonlapsing demand power.²⁷³

The Second Circuit refused to follow the Seventh Circuit's ap-

261. *Id.*

262. *Id.*

263. *Id.* at 120.

264. *Id.*

265. *Id.*

266. *Id.*

267. *Id.* at 121.

268. *Id.*

269. *Id.* at 120.

270. *Id.*

271. *Id.* at 122.

272. *Id.* at 121 (citation omitted).

273. *Id.* at 122.

proach in *Stifel v. Commissioner*.²⁷⁴ Arthur C. Stifel, Jr., created three separate irrevocable trusts for his minor children in 1948.²⁷⁵ The trustee could accumulate income during the beneficiaries' minority.²⁷⁶ Accumulated income would be distributed to the beneficiary at age twenty-one.²⁷⁷ If a beneficiary died before attaining age twenty-one, accumulated income, if any, and trust principal would be distributed to the beneficiary's estate.²⁷⁸ The trust granted the beneficiary the right, which could be exercised during minority by a guardian appointed for such purpose by a court, to terminate the trust, in whole or in part, and to demand distribution of the entire trust at any time.²⁷⁹ However, no guardian had been appointed.²⁸⁰

The Second Circuit rejected the Seventh Circuit's conclusion that restrictions which result from the beneficiary's age rather than under the trust instrument should be ignored:

[I]n *Fondren v. Commissioner* and *Commissioner v. Disston*, the Supreme Court, in determining the nature of the rights conferred by the trust instruments, took account of "surrounding circumstances"; the Court, in reaching its determinations, did not irrevocably lock itself inside the "four corners" of the writings but held that the key might lie outside. Were this not the rule, a donor could make gifts which on paper were 100% present but in practice were 100% future.²⁸¹

The Second Circuit examined the surrounding circumstances in *Stifel* to determine whether anyone was capable of exercising the demand right.²⁸²

The Second Circuit acknowledged that a present interest gift would have been made if the demand right had been given to an adult.²⁸³ But a contrary conclusion was required where none of the children could make the demand (which the court found could only have been made through a guardian) and no guardian had been appointed.²⁸⁴ The court's decision in *Stifel* rested on its conclusion that no one existed who could exercise the demand right.²⁸⁵ It acknowledged that a different result might have been reached if a guardian had been appointed:

If here, for instance, the donor had, in the instrument, appointed a guardian to

274. 197 F.2d 107 (2d Cir. 1952).

275. *Id.* at 108.

276. *Id.* at 108-09.

277. *Id.* at 109.

278. *Stifel v. Commissioner*, 17 T.C. 647, 648 (1951); *aff'd*, 197 F.2d 107 (2d Cir. 1952).

279. *Stifel v. Commissioner*, 197 F.2d 107, 109 (2d Cir. 1952).

280. *Id.* at 110.

281. *Id.* (citations omitted).

282. *Id.* at 110-11; see Note, *Gifts to Minors as Present Interests for Purposes of the Annual Exclusion to the Federal Gift Tax*, 53 COLUM. L. REV. 530, 536 (1953).

283. *Stifel v. Commissioner*, 197 F.2d 107, 109-10 (2d Cir. 1952).

284. *Id.* at 110-11.

285. *Id.* at 111; see *Gifts to Minors as Present Interests for Purposes of the Annual Exclusion to the Federal Gift Tax*, *supra* note 283, at 535.

exercise the children's election rights, or indeed even if a next best friend of the children had successfully petitioned for one at the time the trust first was set up, the result might very well be different. Then there would have been someone who, on the children's behalf, could have made an effective demand. . . .²⁸⁶

If a guardian capable of making the demand had existed, the court opined that it would be appropriate to determine the donor's influence on the guardian.²⁸⁷ The inference is that the court might have employed the substance over form doctrine to determine whether there was an agreement or understanding that the demand power would not be exercised.²⁸⁸

The Second Circuit misinterpreted and misapplied the Supreme Court's use of "surrounding circumstances" in *Fondren and Disston*. The issues in those cases were whether transfers in trust for beneficiaries entitled to distributions for "personal comfort, support, maintenance and welfare"²⁸⁹ and "as may be necessary for . . . education, comfort and support"²⁹⁰ were of present interests. The Court examined the trust instruments and surrounding circumstances to determine whether the trusts granted the donees conditional or unrestricted rights. "In each of those cases, the court was dealing with trust agreements which by their terms contained the restrictions and conditions which led the court to decide that the gifts were of a future interest."²⁹¹ The Supreme Court was not confronted, as was the Second Circuit in *Stifel*, with the grant of an unrestricted right.

The Sixth Circuit followed *Kieckhefer* in allowing the annual exclusion for the transfer of property subject to a nonlapsing demand power in *Gilmore v. Commissioner*.²⁹² It focused on the donee's right to use, possess, or enjoy the property, not on the donee's capacity.²⁹³ The court did not discuss the fact that no guardians had been ap-

286. *Stifel v. Commissioner*, 197 F.2d 107, 110-11 (2d Cir. 1952).

287. *Id.* at 110 n.5 ("It would then seem to be proper to consider the actual facts as to the father's influence on the guardian appointed.").

288. See *Gifts to Minors as Present Interests for Purposes of the Annual Exclusion to the Federal Gift Tax*, *supra* note 282, at 535 (suggesting that the court contemplated use of an illusory transfer analysis).

289. *Commissioner v. Fondren*, 324 U.S. 18, 22 (1945).

290. *Commissioner v. Disston*, 325 U.S. 442, 444 (1945).

291. *Kieckhefer v. Commissioner*, 189 F.2d 118, 120 (7th Cir. 1951).

292. 213 F.2d 520, 522 (6th Cir. 1954). *Gilmore* transferred property in trusts for her seven minor grandchildren. The trustees were required to distribute trust income and principal to the beneficiary upon the beneficiary's demand. If the beneficiary died before trust distribution, accumulated income and trust principal would be distributed to the beneficiary's estate. No guardians had been appointed for any of the beneficiaries. The court held that the trustees' authority to invest in non-income-producing property and to determine whether a beneficiary was incompetent, and, in that case, to make payments for the benefit of the beneficiary, did not result in denial of the annual exclusion. The existence of a spendthrift provision, similarly, had no effect on allowance of the exclusion.

293. *Id.* at 522.

pointed.²⁹⁴ *Stifel* was not mentioned.

In *Perkins v. Commissioner*²⁹⁵ the Tax Court had to decide whether George W. Perkins was entitled to the annual exclusion for transfers to a trust that gave each trust beneficiary, his parent, and his duly appointed guardian the right, at any time, to demand trust principal or accumulated income.²⁹⁶ A guardian had been appointed for only one of the seven minor beneficiaries at the time of two of the gifts.²⁹⁷

The court suggested that under *Stifel*, if the settlor had limited the demand power to the beneficiaries or their guardians, the annual exclusion might have been denied for the transfers where guardians had not been appointed.²⁹⁸ In that case there would have been no one capable of making an effective demand.²⁹⁹ The court, however, did not have to decide between *Kieckhefer* and *Stifel* because the demand "right was also given to the adult parents of the beneficiaries, none of whom appears to have been incompetent to exercise the power thus bestowed."³⁰⁰ Because someone existed who could exercise the demand rights, there was no substantial bar to present use, possession, and enjoyment.³⁰¹ The annual exclusion could have been allowed under either *Kieckhefer* or *Stifel*.

The donor's expectation that the rights would not be exercised did not vitiate "the clear right unmistakably given."³⁰² Regardless of the motive, hopes, or expectations of the taxpayers, the court refused to hold that "the parents of the beneficiaries did not indeed have the right to make such demand at any time."³⁰³ The demand of a parent could not have been resisted by the trustees.³⁰⁴ The substance over form doctrine did not require a different result because "the legal rights in question were created by the trust instruments and could *at any time* thereafter be exercised."³⁰⁵ The court recognized that the

294. *Gilmore v. Commissioner*, 20 T.C. 579, 582 (1953), *rev'd*, 213 F.2d 520 (6th Cir. 1954).

295. 27 T.C. 601 (1956). George W. Perkins created separate irrevocable trusts for his seven grandchildren. The trustees could apply income or principal for the grandchildren's education, support, and maintenance in their discretion during minority. Undistributed income was to be accumulated. Accumulated income and net income were to be distributed to the beneficiary upon attainment of age twenty-one. The trusts would terminate with full distribution to the beneficiary when the beneficiary reached age twenty-five.

296. *Id.* at 603-04.

297. *Id.* at 604-605.

298. *Id.*

299. *Id.* at 605.

300. *Id.*

301. *Id.*

302. *Id.* at 605.

303. *Id.* at 606.

304. *Id.* at 605.

305. *Id.* at 606 (emphasis added).

nonlapsing nature of the demand rights meant the substance of the transaction was consistent with its form.

In *Trust No. 3 v. Commissioner*³⁰⁶ the Seventh Circuit reaffirmed its decision in *Kieckhefer* in an income tax case. Each minor beneficiary or his legally appointed guardian was given the right under the trust to demand distribution of his trust at any time.³⁰⁷ Guardians, however, had not been appointed for any of the children.³⁰⁸ The Seventh Circuit held that trust income was taxable to the beneficiaries under I.R.C. § 678 because of their power to appoint the property in their own favor.³⁰⁹ Completion of routine steps, including the appointment of a guardian, that would have been necessary for exercise of the demand rights did not negate the validity of the rights.³¹⁰

The important facts in each of the foregoing cases were that the donors granted minor beneficiaries, and usually their guardians, immediately exercisable, nonlapsing, demand powers over trust contributions. Separate trusts were created for each beneficiary or separate shares were maintained. With the possible exception of the trust in *Perkins v. Commissioner*,³¹¹ the trust assets were to be distributed to the donee's estate if the donee died before trust termination.

The Seventh Circuit in *Kieckhefer* adopted a purely objective test: Was a right to demand trust property granted?³¹² If so, the transfer qualified for the annual exclusion. The Second Circuit in *Stifel* adopted a two-part objective test: Was a right to demand trust property granted? If so, was there anyone capable of immediately exercising the right?³¹³ The court in *Stifel*, however, suggested that if the two-part objective test had been satisfied, the exclusion might still have been denied under the substance over form doctrine.³¹⁴

306. 285 F.2d 102 (7th Cir. 1960). Charles E. Brehm and Margaret F. Brehm established a trust for their minor children. The trustees could use trust income and principal for the education, comfort, and support of the beneficiaries. Any income not so needed was to be accumulated. The trust was to terminate when a child attained age twenty-five, at which time the trustee was to distribute an equal share of the trust to the beneficiary. If a child died before attaining age twenty-five, the child's share would be distributed to her estate.

307. *Id.* at 104.

308. *Id.*

309. *Id.* at 105-06.

310. *Id.* at 106.

311. Distribution of trust property in the event of death of a beneficiary is unclear from the facts in *Perkins v. Commissioner*, 27 T.C. 601, 604 (1956) ("Various provisions governed the distribution of any remaining principal and income should a beneficiary predecease the trust.").

312. See Dwight Rogers, *Dissents and Concurrences*, *Stifel Stifles Kieckhefer*, 7 TAX L. REV. 500, 502 (1952); see also *Gifts to Minors as Present Interests for Purposes of the Annual Exclusion to the Federal Gift Tax*, *supra* note 282, at 535.

313. *Gifts to Minors as Present Interests for Purposes of the Annual Exclusion to the Federal Gift Tax*, *supra* note 282, at 535.

314. *Stifel v. Commissioner*, 197 F.2d 107, 110 n.5 (2d Cir. 1952).

The demand rights granted the beneficiaries in these cases were immediately exercisable, nonlapsing, general powers of appointment.³¹⁵ General powers of appointment, for tax purposes, have long been regarded by the Supreme Court "as equivalent to ownership of the property subject to the power."³¹⁶ Because the donee of an immediately exercisable general power is able to take immediate possession of the property subject to the power by the mere making of a demand, the donee is treated as the owner of the property for income, gift, estate, and generation-skipping transfer tax purposes.³¹⁷

The transfer of property subject to an immediately exercisable, nonlapsing, general power of appointment should be treated as the equivalent of an outright gift for annual exclusion purposes. The courts in *Kieckhefer* and *Stifel* implicitly recognized this when they assumed that transfers subject to such powers held by adults would have qualified for the annual exclusion. The Tax Court in *Perkins* recognized that the nonlapsing nature of such a demand right meant that the substance of the transaction was consistent with its form. None of the courts, however, cited the tax consequences to the donee as supporting or influencing their decisions on the annual exclusion issue.³¹⁸

-
315. See I.R.C. §§ 2041, 2514. Sections 2041(b)(1) and 2514(c) define a general power of appointment, with certain exceptions, as a power exercisable in favor of the powerholder, his estate, his creditors, or the creditors of his estate. Treas. Reg. § 20.2041-1(b)(1)(as amended in 1961) provides that "if a trust instrument provides that the beneficiary may appropriate or consume the principal of the trust, the power to consume or appropriate is a power of appointment."
316. *Curry v. McCannless*, 307 U.S. 357, 371 (1939); *accord Ryerson v. United States*, 312 U.S. 405, 408 (1941)("[A] present power of disposition for one's own benefit is the equivalent of ownership . . .")(citation omitted).
317. I.R.C. §§ 678, 2514, 2041, and 2652(a)(1). The tax consequences to the donee of a general power of appointment must be considered when such powers are granted. Possession and lapse of a general power of appointment may have adverse income, gift, estate, and generation-skipping transfer tax consequences. See generally Roy M. Adams, *Powers of Withdrawal Held Individually or as a Fiduciary: A Pandora's Box of Tax Consequences*, 23 INST. ON EST. PLAN. 19-1 (1989); William S. Huff, *The "Five and Five" Power and Lapsed Powers of Withdrawal*, 15 INST. ON EST. PLAN. 7-1 (1981); Malcolm A. Moore, *Tax Consequences and Uses of "Crummey" Withdrawal Powers: An Update*, 22 INST. ON EST. PLAN. 11-1 (1988); *Federal Transfer Tax Consequences to the Donee of Annually Lapsing Powers of Withdrawal*, 22 REAL PROP. PROB. & TR. J. 693 (Jeffrey N. Pennell ed., 1987); Charlotte McCown Wilson, Note, *The Crummey Power and Inter Vivos Trusts: An Analysis of Estate, Gift, and Income Tax Consequences to the Trust Beneficiary*, 22 MEM. ST. U. L. REV. 297 (1992).
318. This is not to suggest that allowing the annual exclusion should always correspond with the tax consequences to the donee. While the transfer of property subject to an immediately exercisable, nonlapsing general power of appointment should be treated as the transfer of a present interest, a transfer subject to a testamentary general power of appointment should not. In the latter case, the donee has not received the right to presently enjoy the property, even though the property would be included in his gross estate under I.R.C. § 2041.

The requirement that the donee make a demand in order to obtain the use, possession, or enjoyment of the property subject to the nonlapsing demand power should not result in denial of the exclusion.³¹⁹ It is the right to enjoy,³²⁰ rather than actual enjoyment, that is determinative for annual exclusion purposes.³²¹

The fact that a guardian must be appointed for a minor in order that someone is capable of exercising the demand right should not affect allowance of the annual exclusion. *Kieckhefer*, not *Stifel*, was decided correctly. I.R.C. § 2056(b)(5) allows the marital deduction for the transfer to a spouse of a life estate coupled with a power of appointment in favor of the spouse or her estate. The general power of appointment must be exercisable by the spouse alone and in all events.³²² Incapacity of the spouse will not result in denial of the marital deduction; creation of the power of appointment is sufficient.³²³ Similarly, creation of an immediately exercisable, nonlapsing, general power of appointment should be sufficient to obtain the annual exclusion.

The *Kieckhefer-Stifel* conflict led to enactment of I.R.C. § 2503(c).³²⁴ A transfer for a minor will qualify for the annual exclusion under § 2503(c) if the three requirements of that section are satisfied. The transfer of property subject to an immediately exercisable, nonlapsing, general power of appointment satisfies the spirit, if not the letter, of § 2503(c). First, the property and its income are subject to being expended by or for the benefit of the donee through the donee's (or his guardian's) exercise of the nonlapsing general power of appointment.³²⁵ Second, the beneficiary can obtain the property and

319. See *Heidrich v. Commissioner*, 55 T.C. 746, 753 (1971) ("While making such a written demand [for distribution] might constitute a 'positive act' . . . some sort of positive action, whether it be signing a check or physically grasping a corporate bond, is almost always necessary to place property within one's absolute and immediate possession."); Rev. Rul. 83-108, 1983-2 C.B. 168, 168; Rev. Rul. 80-261, 1980-2 C.B. 279, 280; Rev. Rul. 75-415, 1975-2 C.B. 374, 375 ("The fact that the payment of income or principal is not required to commence immediately but is subject to the demand of the income beneficiary does not constitute a barrier to present enjoyment of the transferred interest contemplated by the Supreme Court.").

320. *Fondren v. Commissioner*, 324 U.S. 18, 20 (1945); *Kieckhefer v. Commissioner*, 189 F.2d 118, 121 (7th Cir. 1951).

321. *Kieckhefer v. Commissioner*, 189 F.2d 118, 121 (7th Cir. 1951).

322. I.R.C. § 2056(b)(5).

323. *Estate of Gilchrist v. Commissioner*, 630 F.2d 340, 343-45 (5th Cir. 1980); *Estate of Alperstein v. Commissioner*, 613 F.2d 1213, 1217-19 (2d Cir. 1979), *cert. denied sub nom.*, *Greenberg v. Commissioner*, 446 U.S. 918 (1980); Rev. Rul. 75-350, 1975-2 C.B. 366, 368.

324. *Leimberg*, *supra* note 138, at 42-25 to 42-26 n.50.

325. The issue under I.R.C. § 2503(c) would appear to be whether the requirement that the minor or his guardian make the demand (or the requirement that a

its income at age twenty-one through exercise of the power.³²⁶ Third, if the minor dies before age twenty-one, the trust estate will be included in the donee's gross estate for estate tax purposes by virtue of the nonlapsing general power of appointment.³²⁷ Moreover, for purposes of § 2503(c), "the fact that under the local law a minor is under a disability to exercise an *inter vivos* power or to execute a will does not cause the transfer to fail to satisfy the conditions of section 2503(c)."³²⁸

The transfer of property subject to an immediately exercisable, nonlapsing, general power of appointment satisfies the three-part annual exclusion test. First, such a power grants the holder the equivalent of outright ownership and should be considered a present interest. Second, the identity of the donee can be determined. Third, the value of the property subject to the nonlapsing demand power can be ascertained.

D. Lapsing Demand Powers

1. *Crummey v. Commissioner*³²⁹

In *Crummey v. Commissioner* the Ninth Circuit had to decide whether the annual exclusion would be allowed for the transfer of property subject to an immediately exercisable, lapsing, general power of appointment where the donee had limited rights in the trust after lapse of the power. On February 12, 1962, D. Clifford Crummey and his wife executed an irrevocable trust for the benefit of their four children.³³⁰ Contributions to the trust were to be divided into separate trusts for the children, unless otherwise designated by the transferor.³³¹ Each child was given the right to demand the lesser of \$4,000 or the amount of a transfer on his behalf on or before December 31st of the year in which the transfer was made.³³² If a child was a minor at the time of the gift or failed in legal capacity for any reason, the child's guardian could make the demand on the child's behalf.³³³

guardian be appointed) makes expenditures subject to "substantial restrictions" under Treas. Reg. § 25.2503-4(b)(1)(1958).

326. See *Heidrich v. Commissioner*, 55 T.C. 746, 752-53 (1971)(continuing right to demand property by giving written notice to the trustee sufficient for purposes of I.R.C. § 2503(c)(2)(A)); see also Rev. Rul. 74-43, 1974-1 C.B. 285, 286.

327. I.R.C. § 2041; see I.R.C. § 2503(c)(2)(B).

328. Treas. Reg. § 25.2503-4(b)(1958). This is consistent with case law holding that capacity to exercise a general power of appointment is irrelevant under § 2041. See, e.g. *Boeving v. United States*, 650 F.2d 493, 495 (8th Cir. 1981); *Williams v. United States*, 634 F.2d 894, 894 (5th Cir. 1981)(*per curiam*); *Estate of Gilchrist v. Commissioner*, 630 F.2d 340, 343-45 (5th Cir. 1980); *Estate of Vissering v. Commissioner*, 96 T.C. 749, 758-60 (1991).

329. 397 F.2d 82 (9th Cir. 1968).

330. *Id.* at 82.

331. *Id.* at 83.

332. *Id.*

333. *Id.*

If no demand was made the addition would continue in trust. Trust income was to be accumulated during the beneficiary's minority unless the trustee made discretionary distributions to a "needy beneficiary."³³⁴ Trust income was to be distributed to the beneficiary between the ages of twenty-one and thirty-five.³³⁵ After age thirty-five, the trustee again had discretion to distribute income and principal.³³⁶ If a child died before age thirty-five, the child's trust would go to the child's surviving issue, if any, or if none, equally to the trusts for the grantors' surviving children.³³⁷

At all relevant times the minor children lived with their parents, and no legal guardians had been appointed.³³⁸ The children were supported by their parents and none ever made a demand against the trust or received any distribution from the trust.³³⁹ The Crummeys made contributions to the trust in 1962 and 1963.³⁴⁰ One of the children was older than twenty-one years of age at the time of the 1962 contribution; two were in 1963.³⁴¹

The Ninth Circuit read *Kieckhefer* as employing a right-to-enjoy test.³⁴² If the court had used the *Kieckhefer* approach, it would have allowed annual exclusions for the transfers for all beneficiaries.³⁴³ The court, however, declined to follow *Kieckhefer*.³⁴⁴ It concluded that allowing the exclusion for transfers subject to the demand rights, without anyone capable of immediately exercising the rights, was too broad on the facts of *Crummey*.³⁴⁵ If the minors could not have made a demand, more than just postponement of enjoyment was involved because the beneficiaries, after lapse of the powers, never again had a right to trust principal.³⁴⁶

The Ninth Circuit read *Stifel* as employing a likelihood of present

334. *Id.* at 86.

335. *Id.*

336. *Id.*

337. *Crummey v. Commissioner*, 25 T.C.M. (CCH) 772, 773 (1966), *rev'd in part*, 397 F.2d 82 (9th Cir. 1968).

338. *Crummey v. Commissioner*, 397 F.2d 82, 84 (9th Cir. 1968).

339. *Id.*

340. *Id.* at 82-83.

341. *Id.* at 82.

342. *Id.* at 85-86. The court stated:

Kieckhefer . . . says that a gift to a minor is not a "future interest" if the only reason for a delay in enjoyment is the minority status of the donee and his consequent disabilities. . . . The court equated a present interest with a present right to possess, use or enjoy. . . . [I]t was really equating a present interest with a present right to possess, use or enjoy except for the fact that the beneficiary was a minor.

Id.

343. *Id.* at 88.

344. *Id.*

345. *Id.*

346. *Id.*

enjoyment test.³⁴⁷ If the court had employed the *Stifel* approach, it would have denied the annual exclusions because it was not likely, considering the surrounding circumstances, that the minors would receive immediate use, possession, or enjoyment of the property.³⁴⁸ The court, however, rejected *Stifel* on the basis that it was "inconsistent and unfair."³⁴⁹ It was no more likely that an adult beneficiary would make a demand than would a minor beneficiary.³⁵⁰ Yet, the I.R.S. would allow the exclusion for the transfers for the adults, but not for the minors.³⁵¹

The court believed it was charting a middle course:

In between these two positions [*Kieckhefer* and *Stifel*] there is a third possibility. That possibility is that the court should determine whether the donee is legally and technically capable of immediately enjoying the property. Basically this is the test employed by the petitioners [taxpayers]. Under this theory, the question would be whether the donee could possibly gain immediate enjoyment and the emphasis would be on the trust instrument and the laws of the jurisdiction as to minors. It was primarily on this basis that the Tax Court decided the present case. This theory appears to be the basis of the decision in *George W. Perkins*. There the Tax Court stated that where the parents were capable of making the demand and there was no showing that the demand could be resisted, the gift was of a present interest.³⁵²

The court concluded that exclusions should be allowed for transfers subject to the lapsing demand rights under "the *Perkins* test or the 'right to enjoy' test in *Gilmore*."³⁵³

The Ninth Circuit determined that the minors' demand rights in *Crummey* could have been exercised in two ways.³⁵⁴ A minor could have informed the trustee that he demanded his share, which would have resulted in the trustee's petitioning for appointment of a guardian.³⁵⁵ Alternatively, a parent could have made a demand as natural guardian for a minor, which would also have led to appointment of a guardian.³⁵⁶

The Ninth Circuit misread *Stifel*. *Stifel* did not rest on a facts-and-

347. *Id.* at 85. The court stated:

As we read the *Stifel* case, it says that the court should look at the trust instrument, the law as to minors, and the financial and other circumstances of the parties. From this examination it is up to the court to determine whether it is likely that the minor beneficiary is to receive any present enjoyment of the property. If it is not likely, then the gift is one of a "future interest."

Id.

348. *Id.* at 88.

349. *Id.*

350. *Id.*

351. *Id.*

352. *Id.* at 86 (citation omitted).

353. *Id.* at 88.

354. *Id.* at 87.

355. *Id.*

356. *Id.*

circumstances determination of whether it was "likely" that the donee would receive immediate use, enjoyment or possession of the property, but rather on the court's conclusion that no one existed who could effectively exercise the demand right.³⁵⁷ The beneficiaries in *Stifel* could not make an effective demand because of the disabilities of minority and because no guardians had been appointed who could have made the demand.³⁵⁸ A present interest might have been found in *Stifel* if guardians had been appointed.³⁵⁹ Surrounding circumstances were used to determine the "nature of the rights conferred,"³⁶⁰ not whether it was likely that the donee would receive present enjoyment. The court concluded that the transfers subject to demand rights were not present interests because no one existed "who could exercise" the rights,³⁶¹ not because the donees were not likely to receive present enjoyment because of financial and other circumstances. Moreover, the dictum suggesting that the court would "consider the actual facts as to the father's influence on the guardian" is suggestive of a substance over form analysis, not a likelihood of enjoyment analysis.

The Ninth Circuit also misread *Perkins*. It characterized *Perkins* as requiring a finding that a demand could not be resisted.³⁶² The Tax Court, however, allowed annual exclusions in *Perkins* because of the "right unmistakably given" and because the donee's parents were given the power to immediately exercise the demand right.³⁶³ *Stifel*'s two-part test was thus satisfied: An immediately exercisable demand right was granted, and someone was capable of exercising the right. If the Tax Court had used *Kieckhefer*'s "right to enjoy" test in *Perkins*, it would not have mattered that the parents could have exercised the right. This suggests that the Tax Court in *Perkins* followed *Stifel*.³⁶⁴ If the parents had not been granted the right to make the demand, the annual exclusion might also have been denied in *Perkins* under *Stifel*.³⁶⁵

The Ninth Circuit's reference in *Crummey* to *Gilmore*'s "right to enjoy" test is also puzzling. *Gilmore* adopted and followed the "right to enjoy" test articulated in *Kieckhefer*. The right to enjoy test is inconsistent with a required showing that "the donee is legally and tech-

357. *Stifel v. Commissioner*, 197 F.2d 107, 111 (2d Cir. 1952); see also *Gifts to Minors as Present Interests for Purposes of the Annual Exclusion to the Federal Gift Tax*, *supra* note 282, at 535; see also notes 281-88 and accompanying text *supra*.

358. *Stifel v. Commissioner*, 197 F.2d 107, 110 (2d Cir. 1952)

359. *Id.*

360. *Id.*

361. *Id.* at 111.

362. *Crummey v. Commissioner*, 397 F.2d 82, 88 (9th Cir. 1968).

363. *Perkins v. Commissioner*, 27 T.C. 601, 605 (1956).

364. Sherman, *supra* note 10, at 658 n.295 (concluding that the Tax Court followed *Stifel* in *Perkins*).

365. *Perkins v. Commissioner*, 27 T.C. 601, 605 (1956).

nically capable of immediately enjoying the property." The existence of the immediately exercisable, nonlapsing, demand right resulted in allowance of the exclusion in *Gilmore*; the court made no finding that the donee was capable of exercising the right.

The Ninth Circuit's approach in *Crummey* requires a determination that the transfer was subject to a demand right and that the donee was legally and technically capable of immediately enjoying the property.³⁶⁶ This is essentially the same test employed by the Second Circuit in *Stifel*.

Notwithstanding *Crummey*, should the annual exclusion be allowed for the transfer of property subject to immediately exercisable, lapsing demand powers?³⁶⁷ Does a transfer subject to such a power satisfy the three-part annual exclusion test?

The annual exclusion should have been denied in *Crummey*, not only for the transfers on behalf of the minor donees, but also for the transfers on behalf of the adult donees. Transfers subject to lapsing demand powers should not qualify for the annual exclusion.

The Ninth Circuit should have adopted *Kieckhefer's* right to enjoy test and engaged in a substance over form analysis. It should have examined the trust instrument and the surrounding circumstances to determine the substance of the transfer for which the annual exclusion was claimed. It was apparent to the court that current benefits were not intended for the donees of the lapsing demand powers in *Crummey*:

366. *Crummey v. Commissioner*, 397 F.2d 82, 86 (9th Cir. 1968).

367. *Crummey* has been the subject of substantial comment and criticism. *E.g.*, Casner, *supra* note 79, at 9-6 ("The annual exclusion, when it can be used in this way [through a *Crummey* demand power], has become a sophisticated estate planning device that permits the accomplishment of goals other than the ones it was designed to achieve."); Dodge, *supra* note 89, at 344 ("The oft-used *Crummey* device should be abolished."); Willard H. Pedrick, *Crummey Is Really Crummey!*, 20 ARIZ. ST. L.J. 943, 948 (1988) ("The decision in *Crummey* must be characterized as a blatant, shocking misinterpretation of Section 2503(b) of the Code."); Vlietstra, *supra* note 175, at 596 ("[R]egardless of its legal support, . . . *Crummey*, amounts to judicial consent to a sham that circumvents the transfer tax system."); Benjamin N. Henszey, *Crummey Power Revisited*, 59 TAXES 76, 77 (1981) ("[T]he IRS is aware that the demand power is a sham in most cases and, as a result, may try to severely curtail it in the future for policy as well as revenue reasons."); Matthew Monippallil, *Life Insurance as an Estate Planning Tool*, TAX ADVISER, May 1990, 308, 317 ("[M]ost irrevocable trusts created today are grafted with *Crummey* powers, demonstrating the most egregious example of form over substance and legalistic ritual over economic reality."); Rothberg, *supra* note 123, described the notice process:

The process can thus take on an unreal quality, carefully choreographed by the attorney or other practitioner, in which a husband gives a notice to his wife on behalf of their new-born child, and neither one understands how such an action so lacking in substance can have tax significance.

Id. at 132-33.

[T]he surrounding facts indicate that the children [were well cared for and the obvious intention of the trustors was to create a long term trust. No guardian had been appointed and, except for the tax difficulties, probably would never be appointed. As a practical matter, it is likely that some, if not all, of the beneficiaries did not even know that they had any right to demand funds from the trust. They probably did not know when contributions were made to the trust or in what amounts. Even had they known, the substantial contributions were made toward the end of the year so that the time to make a demand was severely limited. Nobody had made a demand under the provision, and no distributions had been made. We think it was unlikely that any demand ever would have been made.³⁶⁸

The court, however, focused on the form, not the substance of the demand rights.

The court should have inferred the existence of an agreement or understanding between the donors and donees that the lapsing demand powers would not be exercised. The existence of such an agreement or understanding would have negated the substance and validity of the demand rights. The burden should have been placed upon the taxpayers to disprove the existence of such an implied agreement or understanding. The taxpayers could not have met that burden. If the donees were intended to receive "substantial present economic benefit,"³⁶⁹ the demand powers would have been nonlapsing, and the donees' rights in the continuing trust would not have been limited. The lapsing demand powers appear to have been provided merely to obtain the annual exclusion and to avoid gift and estate taxes. The trust provisions and the surrounding circumstances demand the inference that an agreement or understanding existed that the powers would not be exercised and the conclusion that the transfers were of future interests.

It might seem that denying the annual exclusion for transfers subject to lapsing demand powers is inconsistent with allowing the exclusion for transfers subject to nonlapsing demand powers, because the donee of a lapsing power is potentially subject to the same tax consequences as the holder of a nonlapsing power.³⁷⁰ The disparate treatment is appropriate, however, for several reasons. First, if a lapsing demand power lacks substance for purposes of the annual exclusion, it should follow that the purported donee of the power should not be considered to possess the power for other tax purposes. Second, if that were not the case, the donee will suffer no gift or estate tax consequences unless the property subject to the lapsing power exceeds the greater of \$5,000 or five percent of the value of the property from which it can be satisfied.³⁷¹ Lapsing demand powers are often limited

368. *Crummey v. Commissioner*, 397 F.2d 82, 87-88 (9th Cir. 1968).

369. *Fondren v. Commissioner*, 324 U.S. 18, 20 (1945).

370. See note 317 *supra*.

371. I.R.C. §§ 2514(e), 2041(b)(2); see generally *Huff*, *supra* note 317; *Wilson*, *supra* note 317.

in amount so as to receive the protection of the "five and five" provisions. The income tax consequences of lapsing demand powers admittedly are less certain because I.R.C. § 678 does not contain a five and five exception.³⁷² Third, transfers subject to lapsing demand powers would rarely be used in the gift context if the annual exclusion were not allowed for transfers subject to such powers. Finally, not every transfer that has tax consequences to the donee is or should be entitled to the annual exclusion. A donee who is given a testamentary general power of appointment must include the value of the property subject to the power in his estate at death,³⁷³ but the transferor of property subject to such a power will not be entitled to the annual exclusion.

The transfer of property subject to a lapsing demand power fails to satisfy the first requirement of the annual exclusion test; it is not the transfer of a present interest when considered in light of the substance over form doctrine.

2. Internal Revenue Service's Post-Crummey Position³⁷⁴

The I.R.S. approved use of demand powers to obtain the annual exclusion in Revenue Ruling 73-405:³⁷⁵

[I]t is not the actual use, possession, or enjoyment by the donee which marks the dividing line between a present and a future interest, but rather the right conferred upon the donee by the trust instrument to such use, possession, or enjoyment. A gift in trust to a minor is not a "future interest" if the donee has a present right to the use, possession or enjoyment, although such use, possession, or enjoyment may require the appointment of a legal guardian. [citations omitted]

[I]t is now concluded that a gift in trust for the benefit of a minor should not be classified as a future interest merely because no guardian was in fact appointed. Accordingly, if there is no impediment under the trust or local law to the appointment of a guardian and the minor donee has a right to demand distribution, the transfer is a gift of a present interest that qualifies for the annual exclusion allowable under section 2503(b) of the Code.³⁷⁶

Crummey, *Gilmore*, and *Kieckhefer* were cited as support without discussion or distinction. But those cases involved the transfer of property subject to different demand rights that justified different tax results.

Revenue Ruling 73-405 was ostensibly issued to revoke an earlier

372. Gissel & Rosepink, *supra* note 11, at 138-40; Wilson, *supra* note 317, at 313-17.

373. See I.R.C. § 2041.

374. The Internal Revenue Service has issued numerous rulings in connection with the tax consequences of lapsing demand powers. See Gissel & Rosepink, *supra* note 11 (reviewing numerous administrative rulings issued in connection with demand powers). No good purpose would be served by a review of all the rulings in this article. Only the most significant revenue rulings are discussed.

375. Rev. Rul. 73-405, 1973-2 C.B. 321.

376. *Id.* (citations omitted).

ruling that had denied the annual exclusion for a gift in trust for a minor where no guardian had been appointed. The Service adopted the approach taken in *Kieckhefer* and *Gilmore*; appointment of a guardian at the time of the transfer was not necessary as long as a guardian could be appointed. The ruling took an objective approach consistent with *Kieckhefer*. The focus was on the existence of the demand right; on the "right to enjoy," rather than on actual enjoyment. The existence of someone capable of making a demand was not required as long as a guardian could be appointed. *Crummey*, which required a finding that someone was legally and technically capable of exercising the power, need not have been cited as authority in the ruling.

The Service did not explicitly state in the ruling that a transfer of property subject to a lapsing demand power would be considered a gift of a present interest for purposes of the annual exclusion. *Crummey*, however, was cited as authority. If the Service had not cited *Crummey*, it could have limited the exclusion to the transfer of property subject to nonlapsing demand powers as had been granted in *Kieckhefer* and *Gilmore*. The Service could have rejected *Crummey* and used the substance over form doctrine to deny the exclusion for transfers subject to lapsing demand powers.

In Revenue Ruling 81-7,³⁷⁷ the I.R.S. moved away from the objective approach it had taken in Revenue Ruling 73-405, by relying on *Fondren* and *Disston* in ruling that the circumstances under which a gift is made, as well as the terms of the trust, must be considered in determining allowance of the annual exclusion for transfers subject to lapsing demand powers. If property transferred in trust is subject to limitations on present enjoyment in the form of conditions, contingencies, or the will of another, either under the terms of the trust or other circumstances, the interest will be considered a future interest.³⁷⁸ Moreover, the annual exclusion will be denied if the facts and circumstances show that the donor did not intend to give the donee a present interest.³⁷⁹

The Service acknowledged in Revenue Ruling 81-7 that the annual exclusion could be obtained for the transfer of property subject to a donee's demand power, but indicated the substance over form doctrine could be used to deny the exclusion notwithstanding the demand right (the form) that was apparently granted.³⁸⁰ The Service concluded that a donor who failed to inform the donee of the demand right and restricted the time for exercise to three days had not given the donee a

377. Rev. Rul. 81-7, 1981-1 C.B. 474 (the ruling substantially restated Tech. Adv. Mem. 79-46-007 (July 26, 1979)).

378. *Id.*

379. *Id.*

380. *Id.*

reasonable opportunity to learn of or to exercise the power.³⁸¹ The demand right, consequently, was illusory and the donee had effectively been deprived of the power. Notwithstanding the form, the transfer, in substance, was of a future interest.

In Revenue Ruling 83-108³⁸² the Service for the first time in a revenue ruling³⁸³ explicitly allowed the annual exclusion for a transfer subject to a lapsing demand power.

The I.R.S.'s post-*Crummey* position is that the transfer of property subject to a lapsing demand power can qualify for the annual exclusion. The mere grant of a lapsing demand power in a trust instrument, however, will not be conclusive. The I.R.S. will employ the substance over form doctrine to determine whether the annual exclusion should be allowed. The terms of the trust and the circumstances surrounding the transfer will be examined. The I.R.S. has focused primarily on the length of the demand period and the adequacy of notice in determining the substance of transfers subject to lapsing demand rights.³⁸⁴

3. Reciprocal Lapsing Demand Powers

The I.R.S. addressed availability of the annual exclusion for transfers in trusts containing reciprocal lapsing demand powers in Revenue Ruling 85-24.³⁸⁵ A, B, and C were partners in X partnership. A established a trust and contributed \$20,000. Trust income was to be accumulated for the benefit of A's child subject to the trustee's power to make distributions in certain circumstances. Accumulated income and principal were to be distributed to A's child when the child attained age forty. A's child was given a lapsing right to withdraw up to \$10,000 of any addition to the trust. A's partners, B and C, were given lapsing rights to withdraw up to \$5,000 of any addition to the trust. The rights of withdrawal lapsed after sixty days. B and C had no rights in the trust other than the lapsing demand rights. B and C cre-

381. *Id.*

382. Rev. Rul. 83-108, 1983-2 C.B. 168. The Service allowed the exclusion for a transfer subject to a lapsing demand power for the year of transfer, even though the donee was not informed of the power until the following year. The trustee was required to notify the donee of the demand right within ten days of creation of the trust. The Service distinguished Rev. Rul. 81-7 on the basis that the notice requirement was not to preclude the donee from exercising the right, but rather to ensure that the donee would have the opportunity to exercise the power during the demand period triggered by the notice.

383. The I.R.S. previously had allowed the annual exclusion for transfers subject to lapsing demand powers in numerous private rulings. *E.g.*, Priv. Ltr. Rul. 80-47-131 (Aug. 29, 1980); Priv. Ltr. Rul. 80-44-080 (Aug. 11, 1980); Priv. Ltr. Rul. 80-06-109 (Nov. 20, 1979); Priv. Ltr. Rul. 78-26-049 (Mar. 29, 1978); Priv. Ltr. Rul. 77-42-080 (July 25, 1977).

384. See Gissel & Rosepink, *supra* note 11.

385. Rev. Rul. 85-24, 1985-1 C.B. 329.

ated similar trusts for their children at the same time, giving their children and their partners similar rights of withdrawal.

Taxpayer A claimed annual exclusions in the amount of \$20,000 as a result of the lapsing demand rights given to his child and partners. The I.R.S. acknowledged that "[w]hen a trust instrument gives a beneficiary the power to demand immediate possession of the corpus, the beneficiary has received a present interest."³⁸⁶ But form was not conclusive. Continuing its move away from the objective approach of Revenue Ruling 73-405, the Service stated that the substance of the transaction controls for gift tax purposes.

The Service cited Revenue Ruling 81-7 for the principle that the annual exclusion would be denied if the facts and circumstances show that the donor did not intend to give the donee a present interest or if the demand right was illusory. The Service also discussed the reciprocal trust doctrine as articulated by the Supreme Court in *United States v. Estate of Grace*.³⁸⁷ If two donors establish similar trusts under circumstances such that the beneficial interests are matching, the transfers will be treated as reciprocal whether or not the transfers were actually in consideration of each other.

The Service ruled that A's grant of a lapsing power of withdrawal to B was offset by B's grant of a similar power to A. No gift was made by A to B because the reciprocal powers were based upon adequate consideration. When the powers given to partners B and C lapsed, additional gifts by A to his child became complete. A's total gifts to his child, consequently, were \$20,000, \$10,000 in excess of the annual exclusion amount.

Revenue Ruling 85-24 is consistent with the reciprocal gift and gifts through intermediaries decisions.³⁸⁸ In all of these cases the substance of the transaction must be determined; the form of the transaction is not conclusive of the tax result. The illusory transfer doctrine and reciprocal trust doctrine are simply variations of the substance over form doctrine that the Service and courts must use in the proper administration of the tax laws.

The transfers subject to the reciprocal lapsing demand powers in Revenue Ruling 85-24 represented nothing more than a thinly disguised attempt to obtain multiple annual exclusions for indirect transfers. The ruling is consistent with the decision in *Heyen*³⁸⁹ that gifts through intermediaries will be disregarded in order that the true donee can be identified. Instead of the act of conveyance required of the intermediaries in *Heyen*, inaction on the part of the donees of lapsing

386. *Id.* at 330.

387. 395 U.S. 316 (1969).

388. See notes 219-57 and accompanying text *supra*.

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

demand powers was all that was needed to complete the indirect transfers in Revenue Ruling 85-24.

The Service should have relied upon the substance over form doctrine in Revenue Ruling 85-24, rather than concluding that no gift was involved because the transfers were based upon adequate consideration. What if only one of the partners had established a trust but had given his partners lapsing demand powers?³⁹⁰ The basis of the ruling then would not suffice. The Service would have had to use the substance over form doctrine to deny the annual exclusions on the basis of an inferred agreement or understanding that the lapsing demand powers would not be exercised. It would have had to rule that the lapsing demand powers given to the partners were simply devices by which the taxpayer intended to make indirect gifts, in excess of the annual exclusion amount, to his child free of gift tax.

E. Naked and Semi-Naked Lapsing Demand Powers

1. Internal Revenue Service's Position

As lapsing demand powers became more commonly used to obtain the annual exclusion, the question arose whether the donee of the power had to have a continuing interest in the trust in order for the transferor to obtain the annual exclusion.³⁹¹ Would the transfer of

390. Richard B. Covey, *Recent Developments Concerning Estate, Gift, and Income Taxation — 1985*, 20 INST. ON EST. PLAN. 1-1, 1-114 (1986).

391. See, e.g., John R. Price, *The Uses and Abuses of Irrevocable Life Insurance Trusts*, 14 INST. ON EST. PLAN. 11-1, 11-35 to 11-36 (1980) ("Usually [demand] powers are only given to persons who have a substantial beneficial interest in the trust. If powers were conferred on a broader range of persons, the IRS might attack them as shams."). Mason, *supra* note 175, raised the issue in the context of the appropriateness of *Crummey*:

To assess whether the *Crummey* demand right rule is appropriate, one must first analyze the most important *Crummey* drafting issue: must the donee of a demand right have any relationship to the trust other than as possessor of a demand right? In other words, could A obtain an exclusion for C's demand right by setting up a trust under which B gets the income annually and the corpus in ten years, and C is given a right to demand \$10,000?

Id. at 590. Sherwin P. Simmons, *Drafting the Crummey Power*, 15 INST. ON EST. PLAN. 17-1 (1981) recognized the issue in practice:

In an effort to create an increased number of annual exclusions, some practitioners have adopted the practice of naming as power holders persons who are not real trust beneficiaries. For example, suppose there is an irrevocable trust established for three minor beneficiaries. The donor wants to make a gift to the trust of \$60,000 and he wants to shield the gift by the annual exclusion so as to avoid using any of his unified credit and without paying any tax. How does he do it? Simply by making the gift and naming as power holders 17 of his nephews and nieces in addition to his three minor children. Inasmuch as there are 20 power holders, and, assuming all other requirements for an effective *Crummey* power are satisfied, there should be 20 annual exclusions.

property subject to a naked lapsing demand power (the donee having no right or interest in the trust after lapse of the power) or a semi-naked lapsing demand power (the donee having limited rights or interests in the trust after lapse of the power) qualify for the annual exclusion?

The partners' reciprocal lapsing demand powers in Revenue Ruling 85-24 were naked lapsing demand powers. The Service, however, did not discuss the partners' lack of rights in the trust after lapse of their withdrawal powers. The annual exclusion was denied on the basis that the transfers were for adequate consideration.

The I.R.S. has not issued a revenue ruling in which it has denied the annual exclusion for transfers subject to naked or semi-naked lapsing demand powers on the basis of the absence or limited nature of the donees' interests in the trust after lapse of the powers. The I.R.S. position is reflected in private administrative rulings.

In Technical Advice Memorandum 79-02-007³⁹² the Service allowed the annual exclusion for transfers subject to semi-naked lapsing demand powers granted to the transferor's mother-in-law and father-in-law. The parents-in-law had no enforceable rights in the continuing trust after the lapse of the demand powers, although they could receive distributions of income or principal for their "benefit" in the "absolute discretion" of the trustee. The Service did not suggest that the lack of rights after lapse of the demand powers had any effect on allowance of the annual exclusion.

The Service allowed the annual exclusion for transfers subject to naked and semi-naked lapsing demand powers that could be stripped naked in Technical Advice Memorandum 80-03-152.³⁹³ A trust was established under which the settlor's children and more remote descendants were permissible distributees of income or principal. The settlor's descendants and their spouses were given lapsing demand powers over trust contributions. After the powers lapsed, the spouses had no rights in the continuing trust and the descendants' rights could be eliminated by the exercise of a power of appointment held by the settlor's wife. The Service ruled, nonetheless, that annual exclusions would be allowed for the transfers subject to the lapsing demand powers without any discussion of the rights of the donees in the continuing trust.

In Technical Advice Memorandum 87-27-003³⁹⁴ the Service denied the annual exclusion for transfers subject to naked and semi-naked lapsing demand powers. A husband and wife created separate trusts

Id. at 17-12 (concluding that "there seems something inherently wrong with this arrangement.")

392. Tech. Adv. Mem. 79-02-007 (Sept. 26, 1978).

393. Tech. Adv. Mem. 80-03-152 (October 29, 1979).

394. Tech. Adv. Mem. 87-27-003 (Mar. 16, 1987).

for their two sons. Their expressed desire was that the property remain in trust for the benefit of their sons. Each trust granted the son for whom it was established and the son's spouse, issue, daughters-in-law, and sons-in-law lapsing demand powers. The sons' in-laws had no interest in the trust other than the lapsing demand powers. The sons' children had only remote contingent remainder interests in the trusts after lapse of their powers. Eighteen people, including the sons, were granted lapsing demand powers. The Service stated that the sixteen family members had been added as beneficiaries simply to avoid the federal gift tax through a proliferation of annual exclusions and that "[i]n substance the gifts were intended for the donor's sons C and D." The substance over form doctrine was thus invoked. The problem for the Service was to articulate a basis for denial of the exclusion given case law and its prior rulings.

The Service first distinguished *Kieckhefer*, *Gilmore*, and *Crummey*, on the facts, from the taxpayer in the ruling. It noted that in those cases the minors who had been given demand powers had a beneficial interest in accumulated trust income and usually an interest in trust corpus after lapse of the demand power. In none of the cases did the beneficiary have only a demand power and nothing more, as was the case in the ruling.

The Service then noted that in *Helvering v. Hutchings*³⁹⁵ the Supreme Court had allowed separate annual exclusions for gifts of present interests to beneficiaries in trust, because the annual exclusion was allowed on a per-donee basis for outright transfers. The Court's holding avoided the necessity of creating separate trusts for each beneficiary in order to obtain the separate exclusion. *Hutchings*, however, did not, according to the Service, support allowance of multiple exclusions in the ruling:

[T]he question is whether Congress could have intended that rule [that the annual exclusion applied to each beneficiary of the trust] to apply in the instant case, where none but a single beneficiary of each trust, the grantors' son, had a continuing interest in the trust? It is one thing to conclude, as the Court did, that separate annual exclusions should be allowed for gifts in trust where the donors could have accomplished the same end by creating a separate trust for each beneficiary or by giving each beneficiary a pro rata share of the property outright. It is quite another to conclude that several annual exclusions should be allowed where it would be impossible for the donors to accomplish the same end by creating a separate trust for each beneficiary or by making separate gifts of the property outright.³⁹⁶

The Service allowed the annual exclusion for transfers subject to the adult sons' demand powers, but only for transfers subject to the demand of the other donees where the powers were exercised.

395. 312 U.S. 393 (1941).

396. Tech. Adv. Mem. 87-27-003 (March 16, 1987).

In Private Letter Ruling 88-06-063³⁹⁷ the Internal Revenue Service again allowed annual exclusions for transfers subject to lapsing demand powers where the donees could be stripped naked of their rights in the continuing trust.

The Service allowed annual exclusions for transfers subject to semi-naked lapsing demand powers in Private Letter Ruling 90-30-005.³⁹⁸ Taxpayer A proposed the establishment of a trust of which B would be trustee. During A's life, trust income would be distributed to B, if living, or if not, to B's children, if any. The trustee could use trust principal for B's support, health, and education and could also make discretionary distributions for B's children's special needs and college and postgraduate education. Upon A's death the trust estate would be distributed to B, if living, or if not, one-half to B's children and one-half to A's son, if living. B and B's children were granted lapsing demand powers over transfers to the trust. The Service allowed annual exclusions for transfers subject to B's children's lapsing demand powers without any discussion of their limited rights in the trust after lapse of their powers.

In Technical Advice Memorandum 90-45-002³⁹⁹ the Service returned to the issue of whether the annual exclusion would be allowed for the transfer of property subject to naked and semi-naked lapsing demand powers. Husband and wife transferred \$391,250 in trust during a period of four years. The transfers were subject to fourteen lapsing demand powers. Taxpayers claimed fourteen annual exclusions. If the exclusions were allowed, no taxable gifts were made.

The Service repeated much of what it had said in Technical Advice Memorandum 87-27-003 but expanded on its earlier ruling in an important respect. It employed the substance over form doctrine to infer the existence of an agreement or understanding between the parties that the lapsing demand powers would not be exercised:

Under the facts of this case, where the nominal beneficiaries (other than the Son and the Daughter) enjoyed only remote contingent rights to the remainder, there is no imaginable reason why one of them would not have exercised his withdrawal rights unless there existed some kind of an understanding with the Donors that no one would do so, or they knew that doing so would

397. Priv. Ltr. Rul. 88-06-063 (Nov. 19, 1987). The donees had the right to income from their separate shares and a testamentary special power of appointment. The trustees, however, had the right to terminate the trusts by unanimous decision after expiration of the demand period. If the trustees exercised that power, all trust assets would be distributed to the donor's children, if living. The donor's children were the sole trustees. The donees of the lapsing demand powers, consequently, could be stripped naked by unanimous action of the trustees. Nonetheless, the Service allowed the annual exclusions without discussion of the possible effect of the trustees' power.

398. Priv. Ltr. Rul. 90-30-005 (April 19, 1990).

399. Tech. Adv. Mem. 90-45-002 (July 27, 1990).

result in undesirable consequences of some kind, or both.⁴⁰⁰

The Service inferred the existence of an agreement or understanding in a manner similar to that used by the courts under I.R.C. § 2036(a)(1).⁴⁰¹ The Service concluded that most of the donees were granted lapsing demand powers "simply to avoid the federal gift tax through a proliferation of annual exclusions."⁴⁰² The annual exclusion was allowed only for the transfers subject to the demand rights granted to the "primary" trust beneficiaries.

2. Estate of Cristofani v. Commissioner⁴⁰³

Maria Cristofani wished to give certain income-producing real property to her two adult children.⁴⁰⁴ The property's value was approximately \$280,000.⁴⁰⁵ An outright gift of the property to the children would have greatly exceeded the two \$10,000 annual exclusions available to Cristofani for gifts to her children. Because of the substantial size of her estate it was decided that the annual exclusion would be used.⁴⁰⁶

On June 12, 1984, Cristofani executed an irrevocable trust.⁴⁰⁷ Cristofani's two adult children were the trustees.⁴⁰⁸ Cristofani's two adult children and five minor grandchildren were each given the right to withdraw contributions to the trust, but not in excess of the annual exclusion amount.⁴⁰⁹ The grandchildren were three, six, nine, ten, and twelve years of age at the time of the first transfer.⁴¹⁰ The withdrawal period lasted fifteen days.⁴¹¹ The parents, as trustees, were required to notify their children of their demand rights.⁴¹² The parents were legal guardians of the person of their children.⁴¹³ No demand was ever made.⁴¹⁴

Cristofani's two children were entitled to all income of the continuing trust.⁴¹⁵ The trustees could also distribute principal to themselves

400. Tech. Adv. Mem. 90-45-002 (July 27, 1990).

401. See notes 176-83 and accompanying text *supra*.

402. Tech. Adv. Mem. 90-45-002 (July 27, 1990).

403. 97 T.C. 74 (1991), *acq. in result*, 1992-1 C.B. 1, *action on decision*, 1992-09 (Mar. 23, 1992).

404. Fiore & Ramsbacher, *supra* note 7, at 10.

405. *Id.* at 11 (value of an undivided one-third interest discounted by 25% was \$70,000; consequently the undiscounted value of the entire property was \$280,000).

406. *Id.* at 10.

407. Estate of Cristofani v. Commissioner, 97 T.C. 74, 75 (1991).

408. *Id.*

409. *Id.* at 75-76.

410. See *Id.* at 75.

411. *Id.*

412. *Id.* at 76.

413. *Id.* at 75.

414. *Id.* at 77.

415. *Id.* at 76.

and "were to take into account several factors, including 'settlor's desire to consider the settlor's children as primary beneficiaries and the other beneficiaries of secondary importance.'"⁴¹⁶ After Cristofani's death the trust was to be distributed to Cristofani's children who survived her by 120 days, with a deceased child's share to go in trust to such child's issue.⁴¹⁷ After the grandchildren's demand rights lapsed, they had only contingent remainder interests (contingent on the death of their parent and upon their surviving Cristofani by 120 days).⁴¹⁸ Cristofani died December 16, 1985.⁴¹⁹ Both children survived Cristofani by 120 days, and the trust was distributed to them in equal shares.⁴²⁰

Cristofani conveyed undivided one-third interests in the real property to the trust in 1984 and 1985.⁴²¹ The value of the undivided interests in the property in both years was \$70,000.⁴²² Annual exclusions were claimed for the entire value of the property transferred, as a result of the demand powers granted the children and grandchildren.⁴²³

The Internal Revenue Service allowed annual exclusions for the transfers subject to the children's demand powers but denied the exclusion for the transfers subject to the grandchildren's demand powers.⁴²⁴ The Tax Court allowed exclusions for transfers subject to the demand powers granted to all donees.

The Tax Court held that the test set forth in *Crummey* was the correct test.⁴²⁵ It read *Crummey* as a rejection of a likelihood of enjoyment test:

As discussed in *Crummey*, the likelihood that the beneficiary will actually receive present enjoyment of the property is not the test for determining whether a present interest was received. Rather, we must examine the ability of the beneficiary, *in a legal sense*, to exercise their right to withdraw trust corpus, and the trustee's right to legally resist a beneficiary's demand for payment. Based upon the language of the trust instrument and the stipulations of the parties, we believe that each grandchild possessed *the legal right* to withdraw trust corpus and that the trustees would be unable to legally resist a grandchild's withdrawal demand.⁴²⁶

The Tax Court used the two-part *Stifel-Crummey* test (the grant of a demand right and the existence of someone capable of immediately

416. *Id.*

417. *Id.*

418. *Id.*

419. *Id.* at 75.

420. *Id.* at 76.

421. *Id.* at 77.

422. *Id.* at 77; Fiore & Ramsbacher, *supra* note 7, at 11 (\$70,000 value reflected a 25% discount due to "claimed fractional, unmarketable interests" which was not supported by formal appraisals; the Service did not challenge the discounted value).

423. Estate of Cristofani v. Commissioner, 97 T.C. 74, 77 (1991).

424. *Id.* at 77-78.

425. *Id.* at 81.

426. *Id.* at 83 (citation omitted)(emphasis added).

exercising the right). It held that both requirements were satisfied in *Cristofani*.⁴²⁷

The Tax Court used I.R.S. administrative rulings to support its result. It cited Revenue Rulings 81-7 and 85-24 to show the Commissioner's "recognition that a trust beneficiary's legal right to demand immediate possession and enjoyment of trust corpus or income constitutes a present interest in property for purposes of the annual exclusion under section 2503(b)."⁴²⁸ The court did not note, however, that the Service had indicated in both those rulings that the substance over form doctrine would be used to determine whether the exclusion would be allowed for transfers subject to lapsing demand powers. The court also noted that the facts in *Cristofani* were similar to the facts addressed by the Service in Private Letter Ruling 90-30-005⁴²⁹ in which annual exclusions had been allowed for transfers subject to semi-naked lapsing demand powers. The court, however, failed to mention Technical Advice Memorandum 87-27-003 or 90-45-002, which would have supported a different result.⁴³⁰

The Commissioner tried to distinguish the donees of the demand powers in *Crummey* from the grandchildren donees in *Cristofani* on the basis of their rights in the trusts after lapse of the demand powers. The Commissioner argued that the donees in *Crummey* possessed sub-

427. *Id.* at 83 ("each grandchild possessed the legal right to withdraw"). The court did not discuss the grandchildren's ability to exercise the rights under local law, nor the right of their legal guardians to exercise the rights. The opinion is written on the assumption, however, that someone existed who could legally exercise the rights. *See Id.* at 84.

428. *Id.* at 81.

429. *Id.* at 84 n.5.

430. *See* James C. Cavanaugh & Robert J. Preston, *When Will Crummey Transfers to Contingent Beneficiaries Be Excludable Present Interests?*, 76 J. TAX'N 68, 69 (1992)(concluding that Tech. Adv. Memos. 87-27-003 and 90-45-002 involved facts very similar to those in *Cristofani*). An issue raised by *Cristofani* is the ability of taxpayers to rely on revenue rulings and private rulings. *See* Fiore & Ramsbacher, *supra* note 7, at 10 ("One of the most important issues considered by the Tax Court in *Cristofani* was the Service's inappropriate administrative procedure here—namely, developing new restrictions on *Crummey* powers via private letter rulings that were in substantial conflict with published Revenue Rulings upon which taxpayers traditionally have relied."). But was the Service's position in the private rulings inconsistent with published revenue rulings? The private rulings provide that the substance over form doctrine will be employed to determine the substance of transfers subject to lapsing demand powers. The mere grant of a lapsing demand power does not end the inquiry. If it did, the form selected by the taxpayer would determine the tax result. Revenue Rulings 81-7 and 85-24 are entirely consistent with such an approach. Another issue raised is the effect of the Service's inconsistency in private rulings. That issue is beyond the scope of this article. *See generally* Lawrence Zelenak, *Should Courts Require the Internal Revenue Service to Be Consistent?*, 38 TAX L. REV. 411 (1985); Larry Maples & Robert C. Elmore, *How Consistent Does the IRS Have to Be?*, TAX ADVISER, July 1991, 461.

stantial future economic benefits in trust corpus and income in addition to the demand powers, while the grandchildren in *Cristofani* were secondary beneficiaries⁴³¹ who possessed only contingent remainder interests after lapse of their powers.⁴³² The court did not accept the Commissioner's characterization of the beneficiaries' rights in *Crummey*, noting that the only way a beneficiary in *Crummey* was certain to obtain trust corpus was through exercise of the demand power.⁴³³ More importantly, the court concluded that *Crummey* does not "require that the beneficiaries of a trust must have a vested present interest or vested remainder interest in the trust corpus or income, in order to qualify for the section 2503(b) exclusion."⁴³⁴

The Tax Court also rejected the Commissioner's argument that *Cristofani* never intended to benefit the grandchildren and only gave them demand rights in order to obtain the annual exclusion.⁴³⁵ The court believed that the decedent had intended to benefit her grandchildren.⁴³⁶ First, *Cristofani's* children could have predeceased her and the grandchildren then would have received the remainder.⁴³⁷ Second, the grandchildren were given legal demand rights and events might have occurred that would have prompted them to exercise those rights.⁴³⁸ Finally, the fact that the trust provisions were intended to obtain the annual exclusion did not change the result.⁴³⁹

The court's rejection of the Commissioner's argument that *Cristofani* never intended to benefit her grandchildren must be read as a refusal to use the substance over form doctrine. The court focused primarily on the trust instrument⁴⁴⁰ (the form) rather than on surrounding circumstances, which might have led to the conclusion that the substance of the transaction was inconsistent with its form.⁴⁴¹

Perhaps the court concluded the substance over form doctrine could not be used because the Commissioner had stipulated that the

431. *Estate of Cristofani v. Commissioner*, 97 T.C. 74, 82 (1991).

432. *Id.* at 83.

433. *Id.* at 82.

434. *Id.* at 83.

435. *Id.*

436. *Id.*

437. *Id.*

438. *Id.* at 84. The court suggested that *Cristofani's* children, or their respective families, might have suddenly and unexpectedly been faced with economic hardship or a child might have become insolvent, prompting the grandchildren to exercise their demand powers in order to protect their interests from their parents' creditors. While these possibilities might lend support to the court's conclusion if the demand powers were nonlapsing, they do not when the limited period (fifteen days) during which the lapsing powers could be exercised is considered.

439. *Id.*

440. *Id.* at 84 ("In light of the provisions in decedent's trust, we fail to see how respondent can argue that decedent did not intend to benefit her grandchildren.") (footnote omitted).

441. *Vlietstra*, *supra* note 175, at 590.

grandchildren in *Cristofani* had the same rights of withdrawal as the adult children.⁴⁴² If that was the case, the court erred. The stipulation should be seen merely as an acknowledgement that the trust purported to grant the same demand powers to the children and grandchildren. Examination of the substance of those powers is not foreclosed by acknowledgement of the form employed. Indeed, the Commissioner did not feel that he had conceded the validity of the demand powers. The Commissioner cited Revenue Ruling 85-24 and argued that the donees' failure to exercise the demand rights was evidence of an illusory power or collusive agreement not to exercise the powers.⁴⁴³

Perhaps the court concluded that the substance over form doctrine was not applicable because it found "[t]here was no agreement or understanding between decedent, the trustees, and the beneficiaries that decedent's grandchildren would not exercise their withdrawal rights following a contribution to the children's trust."⁴⁴⁴ But did the court impose the burden on the Commissioner to establish the existence of such an agreement or understanding?⁴⁴⁵ Did the court refuse to infer such an agreement or understanding after considering the terms of the trust and the surrounding circumstances? Did it conclude that the taxpayer had disproved the existence of an implied agreement or understanding? None of these critical questions are discussed in the court's opinion.

Perhaps the court's frequent⁴⁴⁶ and unnecessary⁴⁴⁷ rejection of the likelihood of enjoyment test indicates the court did not appreciate the difference between a likelihood of enjoyment test and the substance over form doctrine. Under a likelihood of enjoyment test a court would presumably determine whether the donee, notwithstanding receipt of title or unrestricted rights in property, was likely to presently enjoy the property. The Seventh Circuit, in *Kieckhefer*, noted that under such a test a gift of a present interest could never be made to a minor:

[N]o illustration is given as to how a gift of a present interest could be made to a minor of tender years. In fact, in oral argument, counsel for the Commissioner, when pressed to give an illustration, was unable to do so other than to suggest that it might be made to an existing guardian. But even so, the use, possession or enjoyment of such a gift would not immediately fall to the mi-

442. *Estate of Cristofani v. Commissioner*, 97 T.C. 74, 82 (1991).

443. *Fiore & Ramsbacher*, *supra* note 7, at 11.

444. *Estate of Cristofani v. Commissioner*, 97 T.C. 74, 77 (1991).

445. *See Cavanaugh & Preston*, *supra* note 430, at 70 (suggesting *Cristofani* means the Service must provide direct, objective evidence in order to establish the existence of such an agreement).

446. *Estate of Cristofani v. Commissioner*, 97 T.C. 74, 80, 81, 83 (1991).

447. The court acknowledged that the Commissioner had not cited or relied on *Stifel* (which is cited as standing for the likelihood of enjoyment test) in its brief. *Id.* at 81.

nor. It could only be used for his benefit and under the law of guardianship in such amounts and at such times as the guardian might deem proper.⁴⁴⁸

The Seventh Circuit rejected such a test when it held that it was the donee's right to enjoy, rather than actual enjoyment, that was determinative for purposes of the annual exclusion. The Service reached the same conclusion in Revenue Ruling 73-405.

Under the substance over form doctrine, the court must examine the trust instrument and the surrounding circumstances to determine whether the form is consistent with the substance of the transaction. The question is not whether the donee is likely to presently enjoy an unrestricted gift. The question is whether there was, in substance, an unrestricted transfer. If an agreement or understanding existed that the lapsing demand powers would not be exercised, the rights are illusory and lack substance. The court erred in *Cristofani* in failing to use the substance over form doctrine⁴⁴⁹ to deny the annual exclusion for transfers subject to semi-naked lapsing demand powers.⁴⁵⁰

In *Commissioner v. Court Holding Co.*⁴⁵¹ the Supreme Court used the substance over form doctrine and held that "[a] sale by one person cannot be transformed for tax purposes into a sale by another by using the latter as a conduit through which to pass title."⁴⁵² *Furst, Schultz, and Heyen* stand for the rule that a gift by one person cannot be transformed for gift tax purposes into a gift by another by using the latter as a conduit through which to pass title.

If *Cristofani* had transferred undivided fractional interests in the property having a value of \$10,000 to each of the grandchildren, and they had conveyed the fractional interests to *Cristofani's* two children within fifteen days, annual exclusions probably would have been denied for the indirect gifts through intermediaries under the authority of *Heyen*. The court could have inferred the existence of an agreement or understanding that the property would be conveyed by the intermediaries to the intended donees. The fact that the transfer by the intermediaries in the case of lapsing demand powers is effected by an act of omission (failure to exercise the lapsing demand power) rather than an act of commission (execution of a deed) does not

448. *Kieckhefer v. Commissioner*, 189 F.2d 118, 121 (7th Cir. 1951).

449. *See Fiore & Ramsbacher, supra* note 7, at 14 (Counsel for the taxpayer in *Cristofani* appears to concede the lack of substance of the lapsing demand powers by asserting "[p]lanning and drafting guidelines for ensuring the availability of gift tax annual exclusions necessarily must take into account the essentially fictional nature of the *Crummey* withdrawal power, even though *Cristofani* strongly supports its viability.").

450. The court should also have denied the annual exclusion for the transfers subject to the adult children's lapsing demand powers on the basis that they were transfers of future interests. *See* notes 367-373 and accompanying text *supra*.

451. 324 U.S. 331 (1945).

452. *Id.* at 334.

change the substance of the transaction, nor should it change the tax result. *Cristofani*, objectively viewed, appears to be little more than a sophisticated indirect transfer case in which the Tax Court in a 16-0 reviewed decision ignored the substance of the transaction and failed to use common sense.⁴⁵³

3. *Post-Cristofani Developments*

In Technical Advice Memorandum 91-41-008,⁴⁵⁴ dated before, but announced shortly after, the decision in *Cristofani*, the I.R.S. denied the annual exclusion for transfers subject to semi-naked lapsing demand powers.⁴⁵⁵ The taxpayer established trusts for her three children and transferred property to the trusts having a value of \$350,000 each year from 1984 through 1987. The taxpayer claimed thirty-five annual exclusions as a result of lapsing demand powers granted to children, grandchildren, and great-grandchildren. None of the demand powers were ever exercised. The Service used the substance over form doctrine and concluded that “[i]t must be inferred that the beneficiaries had reached a prior understanding with the donor that the withdrawal rights would not be exercised.” The existence of such an understanding negated the substance of the demand rights.⁴⁵⁶ Annual exclusions were allowed only for transfers subject to the withdrawal powers of the three “primary” trust beneficiaries.

The I.R.S. did not appeal *Cristofani* and acquiesced in the result.⁴⁵⁷ In acting to recommend acquiescence in the result, however, the Service appears to have flatly rejected the result in *Cristofani*:

The Service does not contest annual gift tax exclusions for Crummey pow-

453. See Harris & Jacobson, *supra* note 7, at 212-13 (referring to the grant of demand powers to secondary/contingent beneficiaries as “the *Cristofani* strategy” and suggesting that “[t]his format is especially beneficial where the grantor desires to make transfers in trust substantially in excess of the annual exclusion available for the number of primary beneficiaries.”).

454. Tech. Adv. Mem. 91-41-008 (June 24, 1991).

455. The decedent established a trust for the benefit of her three children. Separate trusts were maintained for each of the three children. The child for whom the trust was established was entitled to trust income and was given a testamentary special power of appointment to his or her spouse. If the power was not exercised, the trust would be divided into separate trusts for the benefit of the deceased child's issue then living or, if none, would augment the trusts for the other children. The trust provided that the children and their issue or spouses each had a twenty-day right to demand a pro rata share of every contribution, not to exceed, however, the annual exclusion amount. Decedent had three children and twenty-three grandchildren.

456. See Cavanaugh & Preston, *supra* note 431, at 69 (suggesting that this ruling “may signal a shift in the Service's line of attack from the economic interest of the beneficiary to the legal existence of the withdrawal power itself.”).

457. *Acq.*, 1992-1 C.B. 1 (“Acquiescence ‘in result’ means acceptance of the Court but disagreement with some or all the reasons assigned for the decision.”); see also Action On Decision 1992-09 (March 23, 1992).

ers held by current income beneficiaries and persons with vested remainder interests. However, the Service will deny exclusions for powers held by individuals who either have no property interests in the trust except for Crummey powers, or hold only contingent remainder interests. To extend the gift tax benefit of Crummey powers to beneficiaries with interests more remote than current income or vested remainders would undermine significantly the unified system of estate and gift taxation which Congress intended, and would invite flagrant abuse in the future.⁴⁵⁸

The Service indicated it would litigate other cases in which the facts indicate "a greater abuse" of the Crummey power than those in *Cristofani*. And, in recognition of the limited success it might have in the Ninth Circuit (the *Crummey* Circuit), the Service noted "preferably outside the Ninth Circuit."⁴⁵⁹

If the donee of a lapsing demand power need not have a vested present or remainder interest in the continuing trust as determined in *Cristofani*, will the courts allow the annual exclusion for transfers subject to naked lapsing demand powers? Will transfers subject to lapsing demand powers held by donees with only contingent remainder interests, no matter how remote, always be considered present interests? Practitioners are currently seeking to determine the boundaries of the annual exclusion in light of *Cristofani*.⁴⁶⁰

The I.R.S. and courts should not determine the substance of lapsing demand powers by examining the sufficiency of the "clothing" that donors attach to lapsing demand powers. The Service's attempt to distinguish primary and secondary beneficiaries is a fruitless endeavor that essentially concedes that form will be allowed to prevail over substance. When the smoke clears, practitioners will provide donees the minimum continuing interest that courts determine is necessary to obtain the annual exclusion for what, in substance, is always the transfer of a future interest and, in the *Cristofani* setting, also an indirect transfer. Allowing the annual exclusion for transfers subject

458. Action On Decision 1992-09 (Mar. 23, 1992).

459. *Id.*

460. Counsel for *Cristofani* has suggested that *Cristofani* is authority:

[T]o support an increase in the number of \$10,000 tax-free gifts by providing in the irrevocable trust that these *Crummey* withdrawal powers (which are unlikely to be exercised) apply not only to children, but also to more remote contingent beneficiaries, such as grandchildren and spouses of direct descendants. In the above example, assume there are also five grandchildren and that the children all are married (a total of 11 individuals). In such a case, the maximum amount of annual exclusion gifts becomes \$220,000! Thus, all *intended* beneficiaries, whether "primary" (donors' children who receive the entire trust if they survive the parents) or "secondary" (other heirs who only step in for a predeceased child), can hold *Crummey* powers that provide annual exclusions—even though never once does any heir withdraw the permitted \$10,000.

Fiore & Ramsbacher, *supra* note 7, at 14; see also Cavanaugh & Preston, *supra* note 430; Harris & Jacobson, *supra* note 7.

to lapsing demand powers is incompatible with an exclusion limited to the transfer of present interests on a per-donee basis.

IV. ANNUAL EXCLUSION REFORM

A. The Need for Reform⁴⁶¹

The annual exclusion is justified on the ground that taxpayers should be allowed to make customary and occasional gifts of relatively small value without having to pay a gift tax or file a gift tax return. The exclusion provides a limited exemption from the gift tax. The amount of the exclusion and the type of interest that qualifies for the exclusion are important to accomplishing the exclusion's limited purpose. A large exclusion with no limitations on qualifying interests would impair the estate tax protective function of the gift tax. Congress understood this and provided an annual exclusion limited in amount on a per-donee basis for gifts of present interests in property.

The annual exclusion, however, has not always been administered or enforced in a way that reflects these considerations. The exclusion is currently allowed for the transfer of income interests and for the transfer of property subject to lapsing demand powers. Allowing the exclusion for such transfers is inconsistent with the purposes that led to enactment of the exclusion and impairs the estate tax protective function of the gift tax. The donees of such transfers may never receive any economic benefit from the transfers for which the annual exclusion is allowed.⁴⁶² Multiple indirect gifts in the annual exclusion amount can be made to a single donee through the ruse of semi-naked lapsing demand powers. Courts have all too often mistaken form for substance with the result that the exclusion's future interest and per-donee limitations have been compromised.

Reform should accomplish two goals. The first is simplification of the annual exclusion;⁴⁶³ the law should be more certain.⁴⁶⁴ Taxpayers

461. Many have identified the need for annual exclusion reform and made specific proposals. See, e.g., Adams, *supra*, note 73; Casner, *supra* note 79; Dodge, *supra* note 89; Gutman, *supra* note 75; Mason, *supra* note 175; PEAT & WILLBANKS, *supra* note 1; Pedrick, *supra* note 367; Ray, *supra* note 73; Rothberg, *supra* note 123; Sherman, *supra* note 10.

462. The donee of an income interest may die shortly after the income interest is created and before receipt of any income. The donee of the lapsing demand power may fail to exercise the power and have only a contingent remainder interest in the continuing trust.

463. See Edward J. McCaffery, *The Holy Grail of Tax Simplification*, 1990 Wis. L. REV. 1267, 1270-72 (1990). McCaffery suggests there are several different understandings of the term "tax simplification." He identified three types of complexities: "technical complexity" (the pure intellectual difficulty of ascertaining the meaning of a tax law); "structural complexity" (the difficulty in interpreting and applying rules to economic transactions, the room afforded for restructuring transactions to achieve different tax treatment, and the variations in tax treat-

should not have to guess whether a particular transfer would qualify for the annual exclusion. Clear lines should exist over which even the most aggressive of taxpayers would not dare to step. Use of formalistic constructs by which future interests are converted into present interests in order to obtain the annual exclusion should not be possible. Gift and estate planning would be simplified if this goal is realized. The number of cases in which courts would be required to determine the substance of the transaction would be few. Compliance and enforcement costs would be minimal.

The second goal of reform is denial of the annual exclusion for the transfer of certain interests for which it is currently allowed. Transfers of income interests and transfers subject to lapsing demand powers (even if exercised)⁴⁶⁵ should not qualify for the annual exclusion. Allowing the exclusion for such transfers allows abuse of the annual exclusion. This abuse has two aspects. First, the exclusion is allowed for the transfer of future interests. Second, the annual exclusion is

ment contingent on restructuring); and "compliance complexity" (record-keeping and form-completing tasks a taxpayer must perform in order to comply with the tax laws). He also suggested that tax simplification may depend on whether it is considered from the perspective of the taxpayer, the tax preparer, the tax planner or adviser, the IRS, the courts, the legislative system, academics, or economists. The "simplification" advocated herein would reduce all three types of complexities from the perspective of all parties identified.

464. See Willard H. Pedrick, *Larger Bore Canons of Taxation for Federal Estate and Gift Tax Revision*, 10 INST. ON EST. PLAN. 15-1, 15-2 (1976)(noting that Adam Smith offered four "maxims" regarded as the Canons of Taxation, "that taxes should: (1) Be proportionate to income; (2) Be certain and not arbitrary; (3) Be convenient as to manner and time of payment; and (4) Be cheap to collect and not calculated to encourage tax shenanigans . . .").

465. An argument can be made that the exclusion should be allowed for lapsing demand powers that are actually exercised. See Dodge, *supra* note 89, at 345 ("[T]he exclusion should be available if the minor in fact withdraws a cash amount equal to or less than the grantor's prior trust transfer during the same year as the withdrawal."). In *Heyen* the court allowed annual exclusions for two gifts that were kept by the "intermediaries" because "the end result was different." In Technical Advice Memorandum 87-27-003 the Service allowed annual exclusions for transfers subject to naked and semi-naked lapsing demand powers that were exercised. Exercise suggests the lapsing demand right had substance and was not illusory. It could also be suggested that the exclusion should be allowed for exercised lapsing demand powers because exercise eliminates abuse of the annual exclusion associated with such powers. The donee, after exercise, owns the property and has the right to use, enjoyment, and possession. Exercise prevents accomplishment of indirect transfers (assuming the donee does not transfer the property to an intended donee). These arguments have appeal. Under such an approach, however, it would not be possible to determine whether the donor is entitled to the exclusion on the date of the transfer. Lapsing demand powers, moreover, would rarely be exercised. If the donor intended outright ownership by the donee, he would not go to the expense of creating trusts with lapsing demand powers. The tax system is better served by a flat rule denying the annual exclusion for all transfers subject to lapsing demand powers.

allowed for multiple indirect transfers in excess of the annual exclusion amount, free of taxation, in violation of the per-donee limitation. Allowance of the exclusion for these transfers impairs the estate tax protective function of the gift tax. Reform should shore up the future interest and per-donee limitations of the exclusion.

B. Proposed Reform

1. *The Annual Exclusion Amount*

If the gift tax is to accomplish its estate tax protective function and the annual exclusion is to provide a limited exemption for customary and occasional gifts of relatively small value, the amount of the exclusion is important. If the exclusion is too low, gifts of relatively small value will not be exempt and the exclusion will not accomplish its purpose. If the exclusion is too high, transfers will be made in order to avoid the estate tax and the estate tax protective function of the gift tax will be impaired.

The \$10,000 exclusion is sufficiently large that it can be used to eliminate or significantly reduce transfer taxation. Every taxpayer may give present interests in property having a value of \$10,000 per donee each year, to as many donees as desired, free of gift tax through use of the annual exclusion. If a single taxpayer makes qualifying gifts in the amount of \$10,000 per year for ten years to ten donees, \$1,000,000 will have been removed from the donor's estate free of gift and estate taxation.⁴⁶⁶ Future income from the property and post-gift appreciation will also have been removed from the taxpayer's transfer tax base.⁴⁶⁷ If the property transferred would have been subject to estate taxation at the highest estate tax rate, \$500,000 will have been saved as a result of the gifts.⁴⁶⁸ Every gift of \$10,000 will have eliminated \$5,000 of estate tax that otherwise would have been payable. If the taxpayer was married and the spouses consented to gift-splitting, twice as much could have been transferred free of transfer taxation, doubling the tax savings.⁴⁶⁹

Our hypothetical donor with ten donees can transfer \$1,000,000 free of gift and estate taxation each decade through routine use of the annual exclusion. This amount far exceeds the \$600,000 that can be transferred free of gift or estate tax as a result of the unified credit. An annual exclusion gifting program faithfully followed for several

466. This assumes that the transferred property is not required to be included in the taxpayer's gross estate for estate tax purposes under I.R.C. §§ 2035-2038.

467. See PEAT & WILLBANKS, *supra* note 1, § 7.06, at 94.

468. The highest marginal gift and estate tax rate is currently 50%. I.R.C. § 2001(c).

469. See I.R.C. § 2513; Michael B. Lang, *Gift-Splitting by Husband and Wife*, 67 TAXES 623 (1989).

decades can eliminate or significantly reduce a taxpayer's transfer tax burden.

Taxpayers who are unable or unwilling to make full use of the annual exclusion during their lives can aggressively make use of the exclusion on their deathbeds. A taxpayer with a potential taxable estate for estate tax purposes of \$700,000, who has never made a taxable gift, can use the annual exclusion immediately before death to transfer \$100,000 to ten donees (\$10,000 each) and eliminate the \$37,000 of estate tax that would otherwise be incurred. Such use of the exclusion as an estate tax avoidance device is clearly inconsistent with the purposes that supported enactment of the exclusion. But such use will be unavoidable under any exemption provided on a dollar basis unless transfers within a short period before death are included in the gross estate under a flat rule or if "in contemplation of death."⁴⁷⁰

The estate tax avoidance possibilities that exist through routine use of the annual exclusion must be recognized when the amount of the exclusion is considered. The benefits of the exclusion are limited only by the taxpayer's ability and willingness to transfer property during life, the number of individuals he desires to benefit, and the length of his life. Many donors, moreover, apparently make routine maximum use of the exclusion to transfer investment-type assets and ignore small customary gifts, as if such customary transfers are not subject to the gift tax.⁴⁷¹

It has been suggested that the annual exclusion should be "in the range of \$1,000 to \$2,000, a level sufficient to exclude most routine gifts without encouraging elaborate tax avoidance schemes" because a large exclusion "induces tax avoidance and leads taxpayers to view the exclusion as an entitlement."⁴⁷² In 1990, the Joint Committee on Taxation proposed limiting the exclusion to \$30,000 per year on a per-donor basis.⁴⁷³

The exclusion should continue to be allowed on a per-donee basis. If Taxpayer A can give each of his three children \$10,000 per year free of tax, Taxpayer B should be allowed to give each of his six children

470. See SOLOMON, *supra* note 21, § 7.02, at 345-48 (reviewing the history of estate taxation of transfers near death).

471. See Casner, *supra* note 79, at 9-3 ("Some people say, 'Well, I can give up to \$3,000'—the annual gift tax exclusion. But they give \$3,000 and, in addition, they provide the child with a great many other things during the year that are gifts.") (footnote omitted); Cooper, *supra* note 7, at 234 ("In practice, however, the annual exclusion is not used by tax planners to cover casual or support transactions. Instead, the working assumption seems to be that gifts of cash or liquid assets . . . can be made on top of casual and support transactions, which are simply ignored."); Parker, *supra* note 85, at 13-3.

472. PEAT & WILLBANKS, *supra* note 1, § 7.06, at 92; see also Pedrick, *supra* note 367, at 951 (suggesting that an exclusion of \$3,000 might be sufficient to serve the exclusion's original purpose).

473. Harrison, *supra* note 7, at 376 n.51.

\$10,000 per year free of tax. While B can transfer twice as much free of the transfer tax system as A if he makes these transfers, the per-donee approach is consistent with the original purpose of exempting customary or occasional gifts from the gift tax. Such gifts are usually made on a per-donee basis on special occasions (e.g. birthdays, weddings, anniversaries, Christmas) and during the year by expenditures in excess of the taxpayer's obligation of support. If it is believed that the amounts being transferred through use of the exclusion are too large, the exclusion amount, not the per-donee nature of the exclusion, should be changed.

Congress increased the annual exclusion in 1981 to \$10,000, recognizing the reduced value of the annual exclusion due to inflation. Because the exclusion is not indexed for inflation, the value of the exclusion decreases as the purchasing power of the dollar declines. If the exclusion had been indexed to the Consumer Price Index for All Urban Consumers (CPI-U) in 1981, it would be approximately \$15,000 today.⁴⁷⁴ The exclusion, consequently, has lost approximately one-third of its value since 1981.

The exclusion amount, nonetheless, should not be increased. A \$10,000 per-donee annual exclusion should be adequate to cover the customary and occasional gifts of relatively small value made by the vast majority of taxpayers. The \$10,000 exclusion, combined with the tuition and medical expense exclusion, should enable most taxpayers to make customary and occasional gifts and to provide comfortable support for family members without gift tax concerns.⁴⁷⁵

Increasing the amount is not warranted for a second reason. Many donors apparently disregard customary gifts for tax purposes and make full use of the annual exclusion to transfer investment assets.⁴⁷⁶ That practice is likely to continue under any exclusion that is provided on a dollar basis unless the Internal Revenue Service changes its enforcement practices. By limiting the exclusion to \$10,000 in current dollars, approximately one-third of the potential for such abuse will have been eliminated as result of inflation since 1981. An increase in the exclusion amount would expand the potential for abusing the exclusion.

Although the \$10,000 exclusion can be used to achieve substantial gift and estate tax savings, reducing the exclusion amount is not necessary. The generous amount of the exclusion suggests that Congress

474. See *CPI Detailed Report Data for March 1992*, U.S. Dept. of Labor, 69 (May 1992) (if the \$10,000 exclusion had increased at the same rate as the CPI-U from 1981 through 1991 the exclusion would have been \$14,980 on January 1, 1992).

475. See Stephen S. Case, *Lifetime Gifting Strategies After ERTA*, 16 INST. ON EST. PLAN. 12-1, at 12-11 (1982).

476. See note 471 *supra*.

may have intended to err on the high side in setting the amount of the exclusion. Reduction of the amount would be politically difficult.

The \$10,000 annual exclusion, consequently, is an appropriate amount. It affords the intended exemption from gift taxation. While this amount permits some leakage from the transfer tax system, it will not seriously impair the estate tax protective function of the gift tax if the future interest and per-donee limitations of the exclusion are enforced. The exclusion, however, should be indexed for inflation if it is to continue to be sufficient to exempt customary and occasional gifts and enable taxpayers to comfortably support family members without gift tax concerns.

2. *Qualifying Interests*

If the gift tax is to achieve its estate tax protective function and the annual exclusion is to provide a limited exemption for customary and occasional gifts of relatively small value, the type of interest that qualifies for the exclusion is important. If all transfers qualified for the exclusion, transfers that possess none of the characteristics of customary and occasional gifts will be made simply to avoid the estate tax.

In deciding which interests should qualify for the annual exclusion the following questions should be answered: If there were no income, gift or estate taxes, what gifts would most individuals make? What would be the characteristics of gifts that would be made in such a tax-free world? Finally, how would such gifts be made?

In a tax-free world, the average individual might make numerous gifts. He might buy his ten-year-old daughter a ten-speed bicycle or his sixteen-year-old son a used automobile. He might give his adult daughter \$5,000 as a wedding gift. He might send his children to private schools or provide private music lessons. He might take his minor and adult children with him to Hawaii for vacation. He might spend \$500 for each of his children at Christmas. He might give a niece a \$100 birthday gift.

The primary characteristic of all these customary and occasional gifts is that the donees would receive the immediate use, enjoyment, and possession of the gifts and expenditures. They would receive "the right to substantial present economic benefit." Customary and occasional gifts will almost always be gifts of present interests.⁴⁷⁷

In a tax-free world, donors would rarely make future-interest gifts. The donor would retain title and control of his property and its income until the gift was appropriate and immediate use, enjoyment, and possession was intended. Circumstances might change, and the gift might no longer be prudent. Owners would maintain their op-

477. Sherman, *supra* note 10, at 590.

tions. If tax advantages did not exist, gifts would not be made prematurely. Most wealth would be transferred at death.

Customary and occasional gifts are typically made by delivery and conveyance of title. The daughter would receive possession of the bicycle; the son would receive title to the car. The adult daughter would deposit the wedding gift in her personal bank account. Customary and occasional gifts are almost always made outright to the donee; legal and equitable title are not separated.⁴⁷⁸ Christmas, wedding, and occasional small gifts intended for immediate use, enjoyment, or possession by the donee are simply not made in trust.

In a tax-free world, income interests would rarely be transferred inter vivos. If the donor wished to provide another the income from property, he would retain title and simply give the income to the donee as it was earned.

In a tax-free world no one would give a three-year-old child (or the child's guardian) a fifteen-day lapsing demand power over contributions to a trust in which the child had only a contingent remainder interest after the lapse of the power. No one would give unrelated business partners lapsing demand powers over contributions to trusts in which the partners had no interest other than the powers. What would be the purpose of such powers? If the donor intended the child or the partners to have the immediate use, enjoyment, or possession of the property, he would give the property directly to the child (or the child's guardian) or partners.

Two classes of gifts are identified when these questions are answered: Gifts that are not tax-motivated and gifts that are made primarily to obtain some tax benefit. Only the first class of gifts, motivated by pure donative intent, should be excluded, within certain dollar limits, from gift taxation by the annual exclusion. The annual exclusion, therefore, should be limited to gifts of present interests in property: Gifts that give the donee the immediate "right to enjoy" the property; gifts that give the donee "the right to substantial present economic benefit." Transfers of future interests in property should not qualify for the exclusion.

This analysis might suggest that an intent test similar to the one required under the discredited "in contemplation of death" provision of the 1916 estate tax be adopted. It could be argued that only under such a test could it be certain that allowing an exclusion was appropriate. That is not, however, the proposal. Courts should not be required to make such determinations. *Crummey* and *Cristofani* demonstrate that courts are no more likely to reach reasoned decisions in this area than were courts required to use the "in contemplation of death" standard.

478. Sherman, *supra* note 10, at 666-67.

Forty years ago it was suggested that a subjective intent test be avoided in connection with the annual exclusion:

While the necessity of extracting an "intent" from ambiguous wills is the unenviable burden of a probate court, it can scarcely be recommended as an aid to efficiency in routine tax administration. . . .

Where possible, the intent rule should be rejected in tax cases. It is so much simpler to decide "What did the taxpayer do?" than "What did he intend to do?" It is also simpler to decide "What rights did the infant get?" than "Was he old enough and smart enough to exercise his rights effectively?"⁴⁷⁹

An objective test, consistent with underlying tax policies, should be established.⁴⁸⁰ Or, perhaps more accurately, the current objective test should be applied with common sense by the courts.⁴⁸¹

But the objective approach must not be turned into a search for mere form without consideration of substance. Taxpayers will continue to attempt to avoid the future interest and per-donee limitations of the exclusion by carefully structuring trusts and transfers. Until Congress provides a more tightly drawn statute, the I.R.S. and the courts should use the substance over form doctrine in determining whether to allow the exclusion.

A fourth requirement should be added to the three-part annual exclusion test to provide the desired objective test.⁴⁸² In addition to proving that the interest transferred is a present interest, that the donee is identifiable, and that the value of the present interest is ascertainable, the donor should have to prove that the donee received the property outright⁴⁸³ or, if the transfer is in trust, that the property was subject to the donee's nonlapsing demand power⁴⁸⁴ and that the donee was the only trust beneficiary.

The fourth requirement arises from the manner in which customary and occasional gifts of relatively small value are typically made; such gifts are usually made outright and not in trust. The donee receives title to the property transferred. No one other than the donee has rights in the gifts. A consequence of conveying title is that the

479. Rogers, *supra* note 312, at 502.

480. See Dodge, *supra* note 89, at 245 ("An intractable line-drawing problem is best solved not by attempting to refine it, but by defining it away with rules that make line-drawing irrelevant, provided that fundamental tax policy concerns are not significantly undermined.").

481. See Treas. Reg. § 25.2511-1(g)(1)(as amended in 1986).

482. See notes 184-86 and accompanying text *supra*.

483. See Sherman, *supra* note 10, at 666 (proposing that the definition of "future interest" be changed so that the exclusion would be allowed only if the donee received the entire legal and equitable title to the property).

484. The Joint Committee on Taxation has proposed a change in the definition of "present interest" that would require that demand powers be exercisable during the donee's lifetime in order that transfers subject to such powers qualify for the annual exclusion. Harrison, *supra* note 7, at 386 n.109; Moore, *supra* note 317, at 11-30.

donee becomes the owner of the property for income, gift, estate, and generation-skipping transfer tax purposes.

Congress has taken a similar approach in connection with the generation-skipping transfer tax (GSTT) in I.R.C. § 2642(c). When the GSST was enacted in 1986, transfers that qualified for the annual exclusion for gift tax purposes received an inclusion ratio of zero for purposes of the GSST.⁴⁸⁵ Congress subsequently provided, however, that nontaxable gifts to an individual in trust would not receive a zero inclusion ratio, unless no trust income or corpus could be distributed to or for the benefit of any person other than such individual during his life and, if the trust did not terminate before the individual died, the trust assets would be includible in the individual's gross estate.⁴⁸⁶

The amendment of § 2642(c) severely impacted use of lapsing demand powers in the typical long-term, multi-generation *Crummey* trust.⁴⁸⁷ Most trusts containing lapsing demand powers have more than one beneficiary, and the assets will not be included in the donee's estate. If a trust for multiple beneficiaries is to be free of the generation-skipping transfer tax, part of the transferor's generation-skipping transfer tax exemption must be allocated to the transfer.⁴⁸⁸

The fourth requirement is also consistent with the exception to the present interest requirement provided by § 2503(c). Obtaining the annual exclusion under § 2503(c) comes at a cost. The property and its income must be available for the use or benefit of the minor during minority, must pass to the child at twenty-one, and must be included in the minor's estate if the minor dies before the trust terminates. Transfers in trust that do not satisfy the requirements of § 2503(c), but

485. Lawrence Brody, *Putting a Premium on Generation-Skipping Transfer Tax Planning — The Use of Life Insurance*, 23 INST. ON EST. PLAN. 10-1, at 10-49 (1989).

486. Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, § 11703(c)(1), (2), 104 Stat. 1388, 1388-517; Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, § 1014(g)(17)(A), 102 Stat. 3342, 102-3566. I.R.C. § 2642(c) currently provides:

(c) Treatment of certain direct skips which are nontaxable gifts-

(1) In general.—In the case of a direct skip which is a nontaxable gift, the inclusion ratio shall be zero.

(2) Exception for certain transfers in trust—Paragraph (1) shall not apply to any transfer to a trust for the benefit of an individual unless-

(A) during the life of such individual, no portion of the corpus or income of the trust may be distributed to (or for the benefit of) any person other than such individual, and

(B) if the trust does not terminate before the individual dies, the assets of such trust will be includible in the gross estate of such individual.

Rules similar to the rules of section 2652(c)(3) shall apply for purposes of subparagraph (A).

487. Gissel & Rosepink, *supra* note 11, at 133.

488. See I.R.C. §§ 2631, 2632.

which qualify for the annual exclusion, should be subject to similar requirements. Not surprisingly, a trust that satisfies the requirements of § 2503(c) probably satisfies the requirements of § 2642(c).⁴⁸⁹

Recognition of the fourth requirement would not preclude legitimate use of the annual exclusion within the dollar limits determined by Congress. Taxpayers could still make as many per-donee present interest gifts each calendar year as desired. The additional requirement would eliminate annual exclusion abuse by providing clear rules without adversely affecting legitimate use of the exclusion.

C. Judicial Implementation

While courts cannot index the annual exclusion for inflation, they could substantially implement the suggested reform through a reasoned application of the existing three-part annual exclusion test and use of the substance over form doctrine. Common sense could be employed in order to rein in the current unwarranted allowance of the exclusion.

The annual exclusion, as a matter of legislative grace, should be strictly construed. Courts should insist that taxpayers satisfy their burden of proof. The taxpayer must prove that the interest transferred is a present interest, that the donee is determinable, and that the value of the present interest is ascertainable. Actuarial assumptions based on mortality tables should not be allowed in lieu of proof.

Gifts, being transactions almost exclusively within the family group, should be carefully scrutinized to determine if they are, in substance, what they appear to be in form. Courts should infer the existence of an agreement or understanding between the donor and donee where warranted on the facts. The burden of disproving the existence of the agreement or understanding should be on the taxpayer.

The courts should recognize that any taxpayer who wishes to make a present interest gift to a minor or an adult can do so in a number of ways without any tax uncertainty. Property can be transferred outright to the donee. Property can be transferred to a guardian for a minor or incapacitated person. Property can be transferred to a trust over which the donee has a nonlapsing general power of appointment and of which the donee is the only beneficiary. Property can be transferred in a manner that satisfies § 2503(c). Courts should recognize that transfers that do not satisfy the proposed fourth requirement will usually involve attempts to avoid the future interest and per-donee

489. See Lloyd Leva Plaine, *The Million Dollar Question Under the Generation Skipping Transfer Tax*, 24 INST. ON EST. PLAN. 4-1, 4-31 (1990) ("An IRC Section 2503(c) minor's trust for a skip person should meet the TMRA-1988 provisions if the instrument prohibited the use of trust distributions to discharge anyone else's support obligations.")

limitations of the exclusion. The attempts should fail under the substance over form doctrine.

But even if the courts took this approach, there would be significant litigation and a lengthy period of uncertainty. The annual exclusion has been allowed for the transfer of income interests since 1941 and for the transfer of property subject to lapsing demand powers since 1968. It would be wasteful of judicial and administrative resources to whittle away existing law on a case-by-case basis. Allowing the annual exclusion for transfers of income interests and for transfers subject to lapsing demand powers may be "too firmly established to permit such a judicial modification."⁴⁹⁰ A legislative solution is required.

D. Legislative Implementation

Congress should amend § 2503(b) to deny the annual exclusion for transfers of income interests and for transfers subject to lapsing demand powers by adopting the fourth requirement discussed above. It should also index the current exclusion amount for inflation. Enacting these changes would provide the objective approach desired under § 2503(b) and accomplish the goals of reform.

Proposed I.R.C. § 2503

§ 2503. Taxable gifts.

(a) General definition. — The term "taxable gifts" means the total amount of gifts made during the calendar year, less the deductions provided in subchapter C (section 2522 and following).

(b) Exclusion from gifts.

(1) In the case of gifts made to any person by the donor during the calendar year, the first \$10,000 of such gifts to such person shall not, for purposes of subsection (a), be included in the total amount of gifts made during such year.

(2) Paragraph (1) shall not apply to:

(A) gifts of future interests in property; or

(B) gifts in trust for the benefit of an individual unless:

(i) the individual or his guardian (who need not have been appointed at the time of the transfer) has an immediately exercisable and nonlapsing power to demand immediate distribution of the property and the income therefrom; and

490. Mason, *supra* note 175, at 597. ("At a certain point, which *Crummey* has reached, a rule of law becomes so widely accepted and relied upon that it is no longer appropriate for a court to alter it. Such a rule must be changed, if at all, by Congress."); see also Pedrick, *supra* note 367, at 949-50.

(ii) during the life of such individual, no portion of the corpus or income of the trust may be distributed to (or for the benefit of) any person other than the individual.

Legal and equitable life estates and other rights to income shall be considered future interests for purposes of (2)(A).

There are no proposed changes for subsections (c), (e), (f), or (g).

V. CONCLUSION

The annual exclusion is a necessary and appropriate incident of the gift and estate tax system. Taxpayers should not have to render unto Caesar for customary and occasional gifts of relatively small value.

Unfortunately, aggressive taxpayers have been allowed the annual exclusion for transfers in certain circumstances that are inconsistent with the limited purpose of the exclusion. The estate tax protective function of the gift tax is impaired when the exclusion's future interest and per-donee limitations are not enforced. Form has been allowed to triumph over substance. The courts have too often failed to use common sense in determining the availability of the exclusion.

Congress should enact the proposed amendment of I.R.C. § 2503 and index the \$10,000 annual exclusion for inflation. If these proposals were adopted, the exclusion would accomplish its purpose of exempting customary and occasional gifts of relatively small value from the gift tax without impairing the estate tax protective function of the gift tax. The amendment would strengthen the future interest and per-donee limitations of the exclusion. The exclusion would no longer be allowed for transfers of mere income interests or for transfers subject to lapsing demand powers. These changes would simplify gift and estate planning and reduce administrative costs. The resulting annual exclusion, in conjunction with the tuition and medical expense exclusion, would enable most taxpayers to continue to make customary and occasional gifts of modest value and to provide comfortable support for family members without gift tax concerns and without adversely affecting the estate tax protective function of the gift tax.