



TAX ANALYSTS

viewpoints

Gift Tax Repeal: Responding to Opponents' Concerns

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1. Introduction

One of the surprising and anomalous features of the 2001 tax act was that while the estate tax and the generation-skipping transfer tax were repealed in 2010, the gift tax was not. Instead, the lifetime gift tax exemption amount was capped at \$1 million and the rates were lowered. Several commentators — including Jonathan G. Blattmachr, a partner in the New York law firm of Milbank, Tweed, Hadley & McCloy and a prominent estate planner — advanced various arguments to retain the gift tax.¹ Gift tax supporters argue that the tax is necessary to maintain the progressive character of the federal income tax system and to protect state income tax revenue. Although no public record could be located, these arguments appear to have influenced members of Congress and their staff to retain the gift tax under the 2001 tax act.

Gift tax supporters invoked a variety of scenarios under which taxpayers would be able to "game" the income tax system, thereby undermining its progressive character. We believe that those scenarios exaggerate the extent of the potential abuse, and underestimate the ability of the existing and/or new federal and state laws to anticipate and prevent tax avoidance. Consequently, retention of the gift tax is unnecessary to avoid the perceived abuses cited by the commentators. The remainder of the article summarizes each of the major arguments advanced by the proponents of the gift tax and then offers a rebuttal to each argument.

¹Jonathan C. Blattmachr and Mitchell M. Cans, "Wealth Transfer Tax Repeal: Some Thoughts on Policy and Planning," *Tax Notes*, Jan. 5, 2001, p. 393.

II. Discussion

A. Shifting Assets to Lower-Bracket Individuals

Gift tax supporters argue that individuals in high income tax brackets would transfer appreciated assets to relatives and trusted friends in lower income tax brackets or with unused capital losses. On transfer, the recipient would sell the assets, paying lower capital gains taxes than the transferor would have. After some time period, the recipient would return the sale proceeds to the transferor, having retained some amount as "compensation." Without the gift tax, neither the initial transfer nor the return of the sale proceeds would generate tax consequences.

Gift tax supporters insist that, under current law, the IRS does not have the tools for attacking this shift of tax burden, assuming that the interval between the two transfers is sufficiently long and there is no agreement or understanding between the parties requiring the return of the sale proceeds. Further, they contend that the IRS would not be able to effectively close this loophole through new legislation, because of the difficulty of establishing an appropriate period of time during which the gain would be attributable to the transferor.

Rebuttal

While this technique may be used by some, it is unlikely to enjoy wide appeal. First, in the absence of an agreement or understanding, high likelihood and incentive for the recipient would exist not to transfer the proceeds of the sale to the transferor. Furthermore, a possibility always exists that the recipient friend or relative would die or become disabled before the return of the sale proceeds. Thus, only taxpayers with either high-risk tolerance or very trustworthy friends and relatives would be prepared to engage in these transactions. Second, an estate planning attorney may be reluctant to advise his or her client to engage in such transactions because he or she could arguably be counseling the client to engage in possibly fraudulent conduct and possibly violating canons of attorney conduct.

In addition, Congress or the IRS would be able to create rules to prevent this tax burden shift. Establishing a time period during which a return of the sale proceeds would trigger attribution of the gain to the transferor would not be difficult. Tax laws constantly draw apparently arbitrary, yet effective, dividing lines and therefore could do so in this instance. For example, under section 1014(e), if appreciated property was ac-

quired by the decedent by gift during a one-year period before the decedent's death, and it passes back to the donor (or the donor's spouse), the current step-up in basis is denied to that property. Clearly, this rule is designed to prevent individuals from transferring property to friends or relatives who are expected to die shortly, only to receive it back with a stepped-up basis, and was enacted in response to abuses following the implementation of the unlimited marital deduction in 1982. A similar rule could be designed to prevent the manipulation of income tax laws in the absence of the gift tax.

B. Shifting Assets to Foreigners

Gift tax supporters contend that a taxpayer with trusted foreign-based relatives or friends would give them his or her income-producing investment assets (other than real estate) to reduce or entirely avoid income and capital gains taxes. The reason a taxpayer would adopt this technique is that the federal income tax rate on income generated by U.S.-source assets imposed on non-U.S. citizens is only 30 percent, which is lower than the top federal income tax rate for U.S. citizens. (This turns out to be the case even under the 2001 tax act, which lowers the highest income tax rate from 39.6 percent to 35 percent in 2006 and thereafter.) If the income is generated by foreign-source assets, non-U.S. citizens pay no income tax at all. Non-U.S. citizens pay no capital gains taxes on sales of U.S. assets (such as stocks of U.S. companies) other than U.S.-based real estate. Finally, interest paid to non-U.S. citizens on most American bonds is exempt from federal income tax. In the absence of the gift tax, transfers to non-U.S. citizen friends or relatives would not generate tax consequences. Gift tax supporters even posit that the reduction in the capital gains and the income tax burdens would be so attractive, that families would encourage the least wealthy member to expatriate. If that person has modest means at the time of expatriation, he or she would have little difficulty establishing under section 877 that the expatriation was not motivated by tax avoidance.

Rebuttal

Due to several unattractive and limiting features, this technique is likely to be used by only a few taxpayers. First, since this scenario fails to set forth a mechanism by which the U.S.-citizen transferor would have the use of the assets "expatriated" to his or her foreign relatives or friends, the U.S.-citizen would presumably have to rely on the discretion and generosity of foreign relatives or friends to fulfill his or her distribution requests or make periodic outlays. The existence of any understanding or agreement would certainly render the technique ineffective. Thus, the U.S.-citizen would be putting himself or herself in a very precarious position given the high likelihood and incentive for the overseas recipient not to return assets to the transferor. Furthermore, a possibility always exists that the recipient relative or friend will die or become disabled before the technique achieving its purpose. Thus, only taxpayers with either high-risk tolerance or very trustworthy foreign relatives or friends would be prepared to engage in these transac-

tions. Second, the number of individuals who have trusted foreign-based friends or relatives, and would therefore be in a position to take advantage of this technique, is most likely not that large when compared to the number of taxpayers who might potentially want to engage in this type of tax avoidance.

Third, expatriation of a family member to achieve tax advantages is not unheard of but is a drastic measure, especially since the person expatriating would **not be** the one obtaining tax advantages. Practical experience shows that many individuals are averse to changing their U.S. states of residence to reduce an income tax burden, to say nothing of countries. In addition, a U.S. citizen who renounces his or her citizenship for purposes of tax avoidance is taxed for 10 years after renunciation in the same way as a U.S. citizen, and the burden of proof rests on the taxpayer to show that his or her motivation for expatriation was not tax avoidance. Fourth, an estate planning attorney would be reluctant to advise his or her clients to engage in these transactions because he or she could arguably be counseling the clients to engage in fraudulent conduct and possibly violating canons of attorney conduct.

C. Nongrantor Trusts

Gift tax supporters argue that taxpayers would create nongrantor trusts to minimize or avoid income tax. The concern is that a taxpayer would establish an irrevocable trust that can make distributions to him or her. One of the trust's beneficiary's would be a person with a substantial interest in the trust who would be adversely affected if a payment were made to the grantor, and whose consent would be required to make such a payment. Under section 677(a), such a trust would be deemed a separate taxpayer, with its income taxed not to the grantor, but to the trust or any of its beneficiaries.

The concerns of gift tax supporters are valid insofar as even the most carefully designed system of taxation is susceptible to abuse. However, their arguments exaggerate the extent of the potential abuse.

Under sections 663(b) and 662(a), the trustee is allowed to select the beneficiary to whom income will be taxed (for example, the beneficiary in the lowest income tax bracket), as well as the timing for determining that beneficiary's identify (for example, end of the year). If the income is actually distributed to that beneficiary, he or she could return it to the original grantor. If the income is only "credited" to that beneficiary, he or she could let it accumulate in the trust and, after some period of time, consent to the distribution of that income to the original grantor. Under current law, if an adverse party consents to a distribution to the grantor, he or she would be deemed to be making a taxable gift. By contrast, in the absence of the gift tax, neither payment(s) to the original grantor nor the initial transfer to the irrevocable trust would generate tax consequences.

Gift tax supporters also contend that taxpayers would create trusts the income of which would be attributable to a trust beneficiary in a relatively lower income tax bracket than the grantor. This technique would work because, under section 678, a beneficiary with a withdrawal right with respect to trust property is responsible for all income generated by the trust. Such is the case even if, pursuant to the trust provisions, the withdrawal right were to lapse at some future date. After the withdrawal right disappears, the original grantor could be added as a trust beneficiary (by the trustee or another fiduciary), and trust property could be diverted to him or her. Nevertheless, trust income would continue to be taxed to the original beneficiary. In the absence of the gift tax, neither the creation of the trust, nor subsequent payments to the original grantor would generate tax consequences.

Rebuttal

Again, the gamble inherent in these techniques would discourage all but the most risk tolerant or those with *very* trustworthy friends or relatives, who could be made beneficiaries of the irrevocable trust, from engaging in such transactions. In the absence of an agreement that the grantor will receive trust assets, which would render the techniques ineffective, there would be high likelihood and incentive for a nongrantor beneficiary to refuse to consent to a distribution of trust assets to the original grantor, because any such distribution would, by definition, adversely affect the interests of that beneficiary.

In addition, new legislation could be put in place which would prevent such abuses. For example, under the 2001 tax act, new section 2511(c), applicable to gifts made after December 31, 2009, forces a transfer to a nongrantor trust to be treated as a taxable gift. Most commentators interpret the purpose of this provision to be to preclude the use of irrevocable trusts to shift income. If the gift tax were repealed, an analogous provision could deny nongrantor trust status to trusts used for the same purpose. Additional measures would be created to combat the use of lower income tax brackets of trust beneficiaries other than the grantor. Since these measures would address the abuse directly, they would be much more effective than retaining the gift tax as a method of curbing the abuse.

D. Foreign Nongrantor Trusts

Gift tax supporters contend that a foreign nongrantor trust would achieve an even more favorable result than a domestic nongrantor trust in terms of tax reduction because, like a non-U.S. citizen, this trust is generally not subject to U.S. income taxes. The income would be accumulated in the trust tax-free. The trustee would, from time to time, seek the consent of a nongrantor beneficiary to distribute income or principal, otherwise distributable to that beneficiary, to the original grantor. In the absence of the gift tax, neither the initial transfer to the foreign irrevocable trust, nor the subsequent payment(s) to the original grantor would generate tax consequences.

Rebuttal

Existing legislation makes foreign trusts an unattractive tax planning vehicle for U.S. citizens. Thus, the

appeal of this technique is likely to be limited. First, no U.S. citizen could be a beneficiary of such a trust because, under section 679, the income of a foreign trust with U.S.-citizen beneficiaries would be attributable and therefore taxed to the grantor. Thus, the universe of people who could potentially use this technique is necessarily restricted to the individuals who have trusted foreign relatives or friends who could be made beneficiaries of an irrevocable trust. Second, the proposed foreign trusts could only be funded with cash because section 684 imposes a capital gains tax on the transfer of appreciated assets to a foreign nongrantor trust. Thus, the technique would be further limited to taxpayers who either have a significant amount of cash available to justify establishing such a trust, or are prepared to incur capital gains taxes to generate the necessary cash. Third, foreign trusts are saddled with cumbersome reporting requirements which are costly and complex to comply with. Fourth, as with the other techniques discussed above, in the absence of an agreement or understanding between the parties, which would render the technique ineffective, there would be high likelihood and incentive for a nongrantor beneficiary to refuse to consent to a distribution of trust assets to the original grantor, because any such distribution would, by definition, adversely effect the interest of that beneficiary. Thus, only taxpayers with either high risk tolerance or very trustworthy foreign friends or relatives, who could be made beneficiaries of an irrevocable trust, would be prepared to engage in such transactions.

E. Out-of-State Nongrantor Trusts

Gift tax supporters are also concerned that states would lose revenue as taxpayers create nongrantor trusts in states with lower or no state income taxes. The idea is that taxpayers would create nongrantor trusts in jurisdictions such as Alaska, Florida, Delaware, South Dakota, Nevada, Wyoming, Texas, and Washington that have no state income tax and transfer their income-producing investment assets (other than real estate) to such trusts. The technique would be advantageous in two ways. First, the trustee could accumulate income on an ongoing basis and pay the federal income tax due, but no state income tax. Second, at some future date, the trustee could distribute accumulated income to the grantor. Taking advantage of the rule that a trust beneficiary must report as income the trust's income for the year in which the beneficiary receives the distribution, but not income from prior years, the distribution to the grantor could be timed in such a way that he or she would have to report very little, if anything, as income for federal income tax purposes, as well as for state income tax purposes in the state of the grantor's residence.

Gift tax supporters insist that individual states would not be able to pass and enforce laws that would cause their residents to report income on assets transferred to other states, and that the IRS would offer no assistance because federal revenue would not be affected by the manipulation of state income tax systems.

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Rebuttal

A variety of existing and new measures would be available to the states to "capture" trust income, such as attribution of income rules, state grantor trust rules, and anticipatory assignment of income rules, to name only a few. Income-shifting to states with no or lower income tax through the use of nongrantor trusts is nothing new for states to contend with. Many states already have mechanisms in place for combating this practice by, for example, defining trusts with in-state grantors as being subject to state income tax (e.g., Illinois). In addition, the federal government may have a role to play by, for example, collecting revenue on behalf of the states and distributing it to them. Finally, states may have to explore other forms of taxation to supplement the revenue lost due to income shifting to other states.

III. Conclusion

The concerns of gift tax supporters are valid insofar as even the most carefully designed system of taxation is susceptible to abuse. However, their arguments exaggerate the extent of the potential abuse for the following reasons:

1. Many of the tax reduction techniques would appeal to a relatively small group of taxpayers, that is, those with high risk tolerance, those with very trustworthy friends or relatives, and those

prepared to undertake such drastic life changes as expatriation (and would also be able to prove that expatriation was not motivated by tax avoidance);

2. Techniques entailing "foreign" elements would likely have limited appeal because relatively few taxpayers would wish to comply with the cumbersome reporting requirements of foreign trusts, have trustworthy friends or relatives who are non-U.S. citizens, or have significant amounts of readily available cash with which to fund foreign trusts; and

3. Advisors, primarily attorneys, would be reluctant to inform their clients about and assist them with the implementation of many of the transactions because they could arguably be seen as fraudulent and, in all likelihood, would invite IRS scrutiny.

In addition, gift tax supporters underestimate the ability of the existing and/or new federal and state laws to anticipate and prevent abuses.

In any event, the potential risks of gift tax repeal cannot be viewed in a vacuum, but must be weighed against its well-documented benefits. Preserving the gift tax to prevent manipulation of the federal and state income tax systems is akin to using a sledgehammer to kill an ant - it is overkill and an inappropriate remedy for the problems identified.