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Does the Tax Law Discriminate Against the Majority of American Children: The Downside of Our Progressive Rate Structure and Unbalanced Incentives for Higher Education?

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Abstract

Our graduate income tax structure provides an incentive to shift income to lower-bracket family members. However, some parents have much more latitude to shift income to their children than do others. Income derived from services and private business-by far the majority of American income-is less favored than income derived from publicly traded securities. The rationale given for this discrimination is that parents in services or private business, as opposed to those in securities, do not actually part with control of their property. This article explores these tax broader (yet subtle) tax benefits and their impact on the majority of children seeking a higher education. Proposed solutions to this lack of uniformity are discussed.

I. Introduction:

This article is directed at the federal tax law=s lack of consistency in the treatment of parents and grandparents who wish to give some of their income or asset wealth to minor and adult children, particularly for their college education. There is a distinct, yet quite subtle, favoritism accorded to parents and grandparents (and other relatives or friends) who are able to shift income or asset wealth from their publicly-traded securities and other Apassive@ investments to children through custodial accounts and other mechanisms. Those who derive their income from private (non-publicly-traded) businesses and the performance of services, or Aactive@endeavors, are treated much less favorably, forcing them to resort to more costly and more complex methods to shift income to or for the benefit of their children.

In the past few years Congress has added several tax benefits for higher education [1], but

[1] Data on the subject of tax benefits for higher education is as yet incomplete. What limited data is available indicates that there was $13.9 billion in direct grants (for 2001-2002), and $44 billion in student loans and work-study money (in 2001-2002) available for students in higher education. Table 2 of *Trends in Student Aid, 2003*, published by the College Board. The direct benefits available through the tax law, however, are substantially lower. They include education credits of $5.1 billion claimed on only 7.2 million tax returns. Michael Parisi & David Campbell, Individual Income Tax Returns, 2001, in Internal Revenue Service Statistics of Income Bulletin,8, 34 (Fall 2003).

Other tax subsidies, such as the scholarship exclusion, the charitable contribution deduction for all education, the deduction for higher education expenses, the deduction for interest on student loans, the interest exclusion for education bonds, and the exclusion of earnings on education trusts, as listed in the 2003 Tax Expenditure Budget, total around $15 billion. See Excerpt from Estimates of Federal Tax Expenditures For Fiscal Years 2000-2006, Staff of the Joint Committee on Taxation, January 17,

they are generally limited to taxpayers with income under $100,000.[2] However, for a variety

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2002, in MICHAEL J. GRAETZ and DEBORAH H. SCHENK, FEDERAL INCOME TAXATION, Principles and Policies, Revised Fourth Edition at 39-42 (4th ed.2002). The Joint Committee on Taxation, *Present Law and Analysis Relating to Tax Benefits for Higher Education* (JCX-52-04), July 21, 2004 summarizes the various current tax benefits for higher education expenses. Also published in 2004 Tax Notes Today 141-18, July 22, 2004. The JCT estimates total tax expenditures for individuals for 2004-2008 to be almost $50 billion or about $10 billion per year. The Joint Committee on Taxation, Estimates of Federal Tax Expenditures for Fiscal Years 2004-2008 (JCS-8-03, December 22, 2003, at 25.

[2] The I.R.C section 529 state tuition plans are available to taxpayers with higher incomes, but they can be funded only with after-tax dollars (however, income from the accounts accumulate tax-free, with distributions also tax-free if used for qualified education expenses). [The 529 plans are explained in The Joint Committee on Taxation report of July 21, 2004, cited *supra* note 1.] The new low rate on dividends and capital gains may offer greater tax benefits than the much touted § 529 plans. See JOBS AND GROWTH TAX RELIEF RECONCILIATION ACT OF 2003, Law Explanation and Analysis, Commerce Clearing House, at par 305 (2003), stating that Aparents may wish to reconsider the use of other tax-favored savings vehicles such as Code Sec. 529 plans and Coverdell Education Savings Accounts@..

of reasons (some known and some not) these tax credits, exclusions, and deductions are utilized by a small minority of taxpayers and their children. [3] **In fact the most significant tax benefits for higher education have been in the Code for several years, but are subtly buried in the structure of the tax law as a whole.**

[3] See *supra* note 1.

A recent example demonstrates how this indirect preferential subsidy works. The 2003 Tax Act[4] reduced the rate of tax on dividends and most capital gains to a maximum rate of 15%, with a rate as low as 5% (zero percent in 2008) for those (including children) in the lower regular income tax rate brackets.[5] Unless Congress extends these lower rates they sunset after 2008. The main purpose of this legislation was to reduce the burden of double taxation of corporate profits. But, as discussed in Part IIIA below, there is now a new opportunity for passive investors to cut their tax liability by as much as two-thirds by shifting dividend and capital gain income to children or grandchildren, who may then use the income for higher education. This tax subsidy is not available to taxpayers with services income or income derived from actively-operated businesses, who remain taxable at a maximum rate of 35%. This new law provides more in tax incentives for a select number of people (who receive Adividend@ and Acapital gain@ income) than all specific education tax credits combined.[6]

[4]The Jobs and Growth Reconciliation Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, 117 Stat. 752, '' 301-2 , 108th Cong. 1st Sess., H.R. 2.

[5]I.R.C. ' 1(h).

[6] The projected revenue cost of the rate reductions for dividends and most capital gains for 2005 is about $20 billion, and is expected to be higher for years 2006-2008. Estimated Budgetary Effects of the Conference Agreement for H.R. 2, The AJobs and Growth Tax Relief and Reconciliation

We need to explore here some of these broader tax benefits which have favored <u>some</u> taxpayers (based on the *source* of their income) to the implicit exclusion of the majority of American children who would also like to go to college, but have no trust funds or specially created investments for them. This favoritism is brought about through the federal tax laws and must therefore be regarded as a by-product of Congressional tax policy as it relates to support for higher education. While children of wealthier families will obviously have more opportunities to attend college, this paper will focus generally on the horizontal inequity (taxpayers with the same amount of income) and not the vertical inequity (taxpayers with different levels of income) that results in the discrimination addressed.

Part II briefly describes the historical origins of the prohibitions on so-called Aincome-splitting@, and some of their statutory exceptions, Part III then discusses how the graduated rate structure and other features of the income, gift and estate tax laws are directly responsible for freezing out the majority of children in this country from various higher education tax incentives provided, in effect, to only a relatively narrow or targeted group of children whose parents or grandparents derive their income from passive sources.

Act of 2003" Fiscal Years 2003-2013[Joint Committee on Taxation, JCX-55-03, May 22, 2003].

Part IV explores a few alternatives to resolve this discrimination, with a view toward broadening educational opportunities for a larger number of children, without regard to either the source or amount of income of their parents. Some of these alternatives may be far less costly to the government (and more beneficial to our economic and social being) than the present patchquilt of complex and incoherent tax incentives[7]

II. Origins Of The Ban On Income Splitting : Lucas v. Earl and Its Progeny in the American Tax System.

[7]Because of the most recent changes in the rate structure generally, and in the lower rates for dividends and capital gains as well as the lower rates and eventual repeal of the estate tax on transfers of wealth, I will omit discussion in this paper of any revenue gains and losses resulting from all proposals made in Part IV. However, as discussed in Part III, the lower rates for dividends and capital gains enacted in 2003, with rates as low as 5% for those in lower income tax brackets, creates a significant new opportunity for those taxpayers with income from these passive investment sources to shift income to children. [The possible loss of student loan, scholarships, and other financial benefits that might be available for some students because of gifts of assets from their parents is also beyond the scope of the types of discrimination addressed in this paper. It should be noted, however, that the tax savings to those parents discussed in this paper might in many (if not most) cases offset any loss of these student benefits.]

One of the consequences of having a graduated income tax rate structure is the incentive to shift or split income with family members and others in lower tax brackets. While it is assumed that the practice of income splitting has been curtailed, there are a number of mechanisms or strategies employed by taxpayers to effectuate the shift.

In other words, the practice is still occurring in a disguised manner, but only for certain types of taxpayers and certain types of transactions[8] Since we do not have any hard data on the extent or magnitude of income splitting, we should not assume that it does not exist in a more disguised form.

[8]Income shifting is quite pervasive *,outside the family or transfer to children context,* in private businesses, such as partnerships and limited liability companies and AS@ corporations, where the pass-through or conduit structure inherently allows it. The Congressional attempts to curb income (or deduction) shifting that have Ano substantial economic effect@ (I.R.C. 704(b)) are basically flawed. See Lawrence Lokken, *Taxation of Private Business Firms: Imagining A Future Without Subchapter K*, 4 FLA.TAX REV.249 (1999). Much more sophisticated and significant income shifting occurs in the public corporation and its subsidiaries, both in the United States and abroad. This is not simply a result of a graduated rate structure, but more often than not an allocation of profit of loss wherever it will produce the lowest overall tax burden.

The overriding concern against shifting ones income to another person is the direct consequence of having a graduated rate (as distinguished from a flat rate) structure. If all income were taxed at the same rate, without regard to how high or low it was, there would be little or no problem with assigning or splitting income with another taxpayer.[9]

While the Internal Revenue Code did not originally expressly prohibit shifting or assigning income, over 70 years ago the United States Supreme Court held in a classic opinion by Mr. Justice Holmes that the federal tax law would not recognize a valid state

[9]There would be an administrative issue of tracing the liability for taxes on that income to more than one person, but this is already part of the Awarp@ and Awoof@ of an income tax system that readily permits income to be divided among numerous partners, joint owners, and business entities of all types. The standard deduction and dependency exemption do provide some incentive for assigning income to a person with no other income, apart from the graduated rate structure, but this is assumed to be a much lesser concern.

contract by a husband and wife to divide their respective incomes equally.[10] As a result, the husband was taxed on the full amount of his personal services income even though one-half was legally owned by his wife, and even though they entered into this income-splitting arrangement in 1901, during the period when there was no income tax in the United States. Thus, despite the fact that there was no tax-avoidance motive for their agreement, the Court, in an obscurely worded opinion, was presumably protecting the graduated tax rate structure.[11] Nevertheless, the Earl opinion has had a profound impact in creating the so-called Aassignment of income@ doctrine[12] which has been applied in a wide variety of tax cases. While Congress later expressly reversed Earl in 1948, when it enacted the joint return allowing income splitting among spouses, the ban on assignment of income remains in full force for non-spousal income-splitting cases, particularly as it applies to transfers of income to children (whether minors or

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[10]Lucas v. Earl, 281 U.S. 111, 113-115 (1930). Some of the Earl discussion which follows is taken from an earlier piece of mine: Lester B. Snyder, *Taxation with an Attitude: Can We Rationalize the Distinction Between AEarned@ and AUnearned@ Income?*, 18 VA. TAX REV. 241, 259-261 (1998).

[11]Professor Boris Bittker, a leading tax scholar, is quite critical of that decision. AThe opinion in Lucas v. Earl is late-vintage Holmes, magisterial in tone, studded with quotable phrases, and devoid of analysis@. *See* Boris I. Bittker, *Taxation and the Family,* 27 STAN. L. REV. 1389, 1400-01 (1975).

[12]The theory advanced by Holmes is based on the following quoted phrase from the Earl opinion:

AThis case is not to be decided by attenuated subtleties. It turns on the import and reasonable construction of the taxing act. There is no doubt that the statute could tax salaries to those who earned them and provide that the tax could not be escaped by anticipatory arrangements and contracts however skillfully devised to prevent the salary when paid from vesting even for a second in the man who earned it. That seems to us the import of the statute before us and we think that no distinction can be taken according to the motives leading to the arrangements by which *the fruits are attributed to a different tree from that on which they grew.*@ [Emphasis added] *Lucas v.*

adults) and other family members.

The impact of *Earl* is aptly assessed by Professor Bittker:

Earl, 281 U.S. at 114-115.

A Under *Lucas v. Earl,* it became virtually impossible for a taxpayer with income from wages, salaries, or professional fees to shift these items to other taxpayers such as a spouse or child....But dividends, interest, rents, and other forms of investment income were affected very differently by *Lucas v. Earl* than income from personal services. The ›tree= (to use Justice Holmes= metaphor) that produces investment income, according to the courts, was the underlying property itself, so that the income is taxable to the person owning the property when the income arises. Thus, taxpayers wanting to shift the tax liability for investment income to their spouses or children found it possible to do so with impunity, if they were prepared to give up ownership of the underlying securities, bank account, rental real estate, or other property.@[13] In other words, a partial transfer of a few shares of stock would suffice to shift the income from those shares.[14] Taxpayers who derive their income from services however are thus excluded from any income-shifting to children. There is no statute, as such, proscribing this result; simply a carryover of *Earl*.

Thus, *Earl* as such does not prohibit all parental shifting of income to their children. Those who have publicly-traded stocks or securities which pay dividends and/or which have appreciated in value have a clear and direct path to shifting income taxes on the dividend

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[13]Bittker, *supra* note 11 at 1401.

[14]Cf. *Helvering v. Horst*, 311 U.S. 112, 120 (1940), where the Court (with three dissenting opinions disagreeing with *Earl)* held that a gift of interest coupons from bonds held by the father did not shift the fruit from his tree, consistent with *Earl*.

income and unrealized gain to adult or minor children or grandchildren. Parents or grandparents who have other types of property, such as interests in closely-held businesses, real estate, copyrights, and other intellectual property have to utilize indirect and often complex mechanisms in their attempts to shift income to their offspring. These indirect devices, such as family partnerships, gift/leasebacks, private annuities, etc., are more often than not regarded with suspicion by the Internal Revenue Service, resulting in more costly financial and legal planning with a high probability of litigation.

The proposals suggested in Part IV have the potential of partially resolving contentious issues of the day, such as financing private and public education, without engaging in policy and constitutional conflict. Revising or eliminating the *Earl* prohibition on assignment of income, and replacing it with a normative incentive to assign income to children, would have a more positive impact on broadening the higher education student base for the majority of American children.[15]

[15] Although this article is not directed at the education grants available to low-income citizens who pay little or no taxes, the proposal suggested in Part IV could be in the form of a refundable tax credit (similar to the earned income tax credit in I.R.C. § 32). By folding in some of the non-tax subsidies with the proposed tax credit, the revenue impact may be far less onerous on the federal government.

One major rationale for the generic ban on income-splitting with minor children under current tax law is the theory of Aparental control@.[16] It is presumed that any transfer of an asset to a minor is in reality not a transfer at all because of the *de facto* control of the asset by the parent. I will argue that this rationale merely disguises favoritism for some types of parental gifts over others. There are a number of different methods for accomplishing income and wealth shifts to children and others. Some work, others do not, but they are often only superficially different. Indeed, the Aaccepted@ methods are more often than not substantively equivalent to other methods which are *verboten*. With careful (often Aclever@) drafting of legal instruments by astute lawyers, a substantial amount of income and wealth may be transferred to children during the lifetime of a parent, resulting in much lower tax burdens. Yet parental control is retained through some artificial, yet legal, entity or structure, such as a trust, a family limited partnership, a private annuity, a disguised installment sale, or a gift and leaseback arrangement.[17]

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[16] For an analysis of the control and other theories of tax law in expenditures for children, including a Aconsumption@ expense theory, see Lawrence Zelenak, *Children and the Income Tax,* 49 TAX L. REV. 349, 359-61 (1994), Zelenak, *Marriage and the Income Tax,* 67 S. CAL.L. REV. 339, 354-58 (1994). For an economic analysis of the costs of raising children, see Thomas J. Espenshade, INVESTING IN CHILDREN (1984).

[17]The attitude of the courts toward family partnerships, for example, often regarded as tax avoidance devices, is reflected in the Tax Court=s statement that AFamily partnerships must be closely scrutinized by the courts because the *family relationship ›so readily lends itself to paper arrangements having little or no relationship to reality=@*. Estate of Albert Strangi v. Commissioner, 115 T.C. 478, 484 (2000) [Emphasis added]. Yet the court went on to hold that despite the partnership=s lack of business purpose, the partnership legally changed the relationships between decedent and his heirs. <u>Strangi</u> was partly reversed on appeal to allow the IRS to pursue its claim in the

Tax Court that decedent retained a life estate under I.R.C. 2036, similar to the parental retention of control theory discussed in this article. Rosalie Gulig (on behalf of Estate of Strangi) v. Commissioner, 293 F.3d 279 (CA-5 2002). On remand to the Tax Court, the Estate was required to include the property in the gross estate. T.C. Memo 2003-145. [However, the Fifth Circuit recently rejected the government's use of Section 2036 in a transfer of $2.5 million mostly in investment assets connected to the decedent's oil and gas business to a family limited partnership on the theory that the transfer was a "bona fide sale for an adequate and full consideration in money or money's worth" under the exeception in 2036(a)(1). As a result, the property was removed from the estate of the 96 year-old decedent. But the Court did remand the case to the District Court on the issue of whether the decedent retained and interest in property initially transferred to an LLC which then made the transfer of assets to a family partnership. Kimbell v. United States, 371 F.3d 257 (5th Cir. 2004). For a critical analysis of this decision see Brant J. Hellwig, "Kimbell v. United States: The Rise and Apparent Fall of the Section 2036 Argument Against FLPs", 104 Tax Notes 517, August 2, 2004.

Obviously, there remains much uncertainty and costly litigation as to the future resolution of these issues. Years may go by before the issue the conflict among the courts is resolved (or partially resolved) by the U.S. Supreme Court or Congress.]

III. Income-Shifting In Three Contexts:

A. Publicly-Traded Stocks and Securities:

Stocks or securities of major corporations which are publicly traded in the financial markets generally can be transferred to children with the least difficulty[18], but with the highest probability of tax savings to the transferor-donor during her lifetime. Consider the following example:

[18] Publicly-traded securities would include other investments, such as options, straddles, real estate investment trusts, etc, which are normally traded in the securities markets. Privately-owned real estate is generally controlled by a small number of persons, making transfers of pieces of the property to children a more difficult task than transfers of public securities.

Mother owns (among her many other assets) 10,000 shares of G, Inc. stock (publicly-traded) which she purchased several years ago for $10.00 per share or $100,000. The stock, which is now trading at $100.00 per share (thus having a total fair market value of $1,000,000) has been paying regular annual dividends to Mother of $8.00 per share or $80,000. Her federal income tax liability on these dividends in tax years 2003-2008 amounts to $12,000 per year at the highest marginal tax rate of 15% [19], although her tax liability in years before 2003 and after 2008 would be around $28,000, assuming a maximum rate for those years of 35%. Since dividends and capital gains can be taxed as low as 5% from 2003 to 2008[20], even with the Atemporary@ 15% rate , a parent can save another 10% ($8,000) per year by shifting some stocks to her children.[21] Assume Mother is 50 years old ,widowed, and has four children, ranging in ages from 15 to 21. Her other stocks and assets are estimated to be worth $5,000,000.

[19] State income taxes have been disregarded throughout this article, but in states such as California and New York, residents would pay another 9%-10% tax on these dividends. Assuming Mother in our example lived in one of these states, her total net rate of taxes (state and federal), after deducting the state tax on her federal income tax return, could run as high as 20%-25%. California's highest income tax rate is 9.3% [Cal.Rev.&Tax Code,Section 17041(a)]. New York's highest state income tax rate is 7.7%, with another 2% for New York City residents [New York Consolidated Law Service, Tax Law, Art.22, Personal Income Tax, Section 601 (2004); New York Consolidated Law Service, General City Law Art.2-D, City Personal Income Tax on Residents, Section 3.].

[20]See *supra* note 4 and accompanying text.

[21]The new 5% for dividends and capital gains applies to those in the regular 10%-15% lower income tax bracket. Thus, a child with under $28,400 (2003 rates) of taxable income is taxed at 5% on dividends and capital gains. I.R.C. '' 1(h)(3),(11).

Mother decides to give each of her four children $250,000 worth of the G, Inc. stock, all in one year or over 4-5 years. In discussing the probable income and gift tax consequences I will concentrate on the main thesis of this article, from a policy perspective, and include only an overview of the technical planning rules.

In this scenario, Mother will have no taxable gain on the gift of appreciated property to her children. Her gift tax exclusion of $1,000,000[22] eliminates any wealth transfer tax on this stock transfer. She can effectively shift the income taxation of the $80,000 in annual dividend income to her children, provided she follows well-defined steps.

[22]The Economic Growth and Tax Relief Reconciliation Act of 2001; Pub L. No. 107-16, 115 Stat. 38, 71-72 (codified as amended at I.R.C. § (2005).

The simplest method is to transfer the stock to a custodianship account for each child under 21, pursuant to the Uniform Transfer to Minors Act which has been adopted in one form or another in all states.[23] The custodian, who should be a third person or financial institution, is empowered to accumulate the income until the child reaches 21[24], at which time it must be distributed to the child. So long as the income is not used to legally support the child, the accumulated income is taxed directly to the child.[25] Assuming the children have no other taxable income, the total income tax liability for the four children on their total share of the dividend income would be no more than $4,000 per year (5% x $80,000), or $8,000 less, each year, than would have been paid by their Mother had she not made the gifts. By delaying the transfer of the stock to the custodian until the minor reaches 14 years of age, the children avoid the so-called AKiddie Tax@ which taxes Aunearned@ income, such as the dividends in this case, at the parent=s higher rate bracket.[26] In years prior to 2003 and after 2008 (assuming Congress

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[23] The Commissioners on Uniform State Laws have promulgated such Acts. The Acts vary somewhat from state to state, but the revised Uniform Transfers to Minors Act (UTMA) is at 8B U.L.A. 497 (1993).

[24] This is most often the case even though the age of majority in a particular state may be under 21.

[25] The use of a trust instead of a custodian account while the children are minors is now less satisfactory for income tax purposes. Since 1993, Congress compressed the rate brackets for the income accumulated by a trust so that the highest rate bracket (35 %), after adjustment for inflation, is now reached at $9,550. [This is the dollar amount for 2004 based on changes in the Consumer Price Index. See Revenue Procedure 2003-85, Sec. 3, 2003-49 I.R.B. 1184]. However, trust income which is <u>distributed</u> to a beneficiary is taxed at the normal rate schedule. I.R.C. Section 1(e). *<u>Cf.</u>* <u>I.R.C.§</u> 677, which taxes a grantor on income of a trust used to satisfy a grantor=s obligation of support.

[26] I.R.C. § 1(g). The child's income tax liability may be further reduced by the child's standard deduction. Where the child is under age 14, the Kiddie Tax can be avoided by transferring low-yield

does not retain this rate reduction), Mother would save $16,000 per year. If each of the children should sell the stock (even during the 2003-2008 period) for $250,000, their $225,000 capital gain (donor=s basis of $25,000 for each donee)[27] would be taxed at no more than 15%.

Even though this is the same rate as Mother would pay if she sold the stock while she owned it, the Atime value of money@ principle works to the family=s advantage where the deferral of a Arealized@ taxable gain, coupled with the tax savings on shifting the dividend income to the children, could potentially result in a significant tax savings to the family. In addition, by parting with control of the shares of stock given to her children (something that is more difficult in closely-held businesses and impossible for services taxpayers who would like to shift a portion of their services income to children), Mother has eliminated these stocks from her estate for wealth transfer purposes.

Since publicly-traded stocks are passive investments not requiring any management activity by the owner, the custodian device, intended originally only for these stocks, serves the goals of parents who wish to lower their income tax liability. The corporation simply sends the dividend checks to the custodian who then deposits them in an account for the child. The more elaborate trust structure is unnecessary for this type of property unless the parent wishes to curtail the

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stock, which is expected to increase in value after age 14.

[27]I.R.C. § 1015(a).

use of the income by the child after age 21. In most cases the children expend the accumulated income for their education or support after they reach majority.

Mother's transfer of the stock to her children also results in wealth transfer tax savings. There are two components of the wealth transfer tax- a gift tax to the donor on lifetime gifts and an estate tax on gifts taking effect at the decedent=s death. There is a one-time unified credit equivalent to $1 million ($1.5 million in 2004) of wealth, increasing to $3.5 million by 2009, after which it sunsets in 2010, and reappears in 2011 restoring pre-2001 levels of tax.[28] In addition, a donor may exclude $10,000 per year per donee ($20,000 if her spouse consents),[29] provided the gift constitutes a Apresent interest@ in the property to the donee[30]. Gifts to minors qualify as

[28]Economic Growth and Tax Relief Reconciliation Act of 2001, Pub.L. No., 107-16, 115 Stat. 38. The gift tax, however, with a $1,000,000 lifetime exclusion, remains in a new role as a Abackstop@, not to the estate tax, but to the income tax. The apparent theory is that taxpayers could give assets to lower bracket family members for a few years, pay no gift tax, but shift income to lower bracket members, who could then re-gift the assets back to the original donor also without a gift tax.

[29]I.R.C. § 2503(b). The exclusion is increased by a cost-of-living adjustment, which was $1,000 for 2003. Thus the amounts were increased to $11,000 and $22,000 (with spousal consent). I.R.C. § 2513.

[30] A recent case illustrates how a gift of interests in a family tree farm business, in the form of a Limited Liability Company, did not qualify for the annual gift tax exclusion. Albert J. Hackl, Sr. v. Commissioner, 335 F.3d 664, 665-668 (7th Cir. 2003). The court determined that the donor parents retained control over the interests transferred. Unlike ownership shares in a public corporation, which can be easily separated from the donor=s retained shares, a gift of ownership interests in smaller businesses cannot be separated, practically, from the retained shares. This may be an appropriate result for other tax policy reasons, but it is difficult to justify this distinction, other than its formalistic nature, as a means of banning assignments of income for income or wealth transfer tax purposes.

present interests even though held in an accumulation account by a custodian[31].

In addition to the $1,000,000 lifetime credit, taxpayers are also able to avoid gift tax liability, entirely, by paying tuition to an educational organization on behalf of any individual.[32]

A gift of publicly-traded stock also avoids the complex valuation rules where, as in gifts of closely-held business interests and real estate, for example, the donor retains a life or other interest in a portion of the property transferred. Congress regarded these split interest gifts (a practical necessity in private businesses) as devices to avoid gift and estate tax by subtracting the retained interest from the value of the transferred interest. Legislation enacted in 1990 in effect increases the value of the transferred interest and thus the gift tax paid by the donor.[33]

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[31]Income from property transferred to a trust for the benefit of a minor can also qualify as a Apresent interest@ for the gift tax annual exclusion even though the trust accumulates the income until the child reaches age 21; however, as mentioned above, for income tax purposes the accumulated income is taxed at the higher marginal rates. One would then weigh the gift/estate tax savings against the higher income tax rates (but no higher than the donor=s rates).

[32]I.R.C. ' 2503(e). This exclusion is not restricted by the normal $10,000/$20,000 annual exclusion in I.R.C. 2503(b) and thus does not come within the Apresent interest@ requirement. Thus, a taxpayer with minor children or grandchildren can pay all their college tuition, without gift tax liability.. In this instance, we=re talking about wealthier taxpayers who are affected by the gift tax, some of whom derive their income from non-publicly-held securities or even from services. Services taxpayers, however, could pay the tuition only with after-income tax dollars.

[33]I.R.C. § 2701. For an explanation of the operation of this provision, see Boris I. Bittker ET AL., Federal Estate and Gift Taxation, 90-96 (8th Edition, 2000). Section 2701 imposes special gift tax valuation rules, where, for example, the controlling shareholder of a closely-held corporation, attempts to shift the future appreciation in value of her stock to her children by an Aestate freeze@ technique. The parent gifts the common stock to her children, and retains preferred stock with voting control, an annual

This section is generally not applied to publicly-traded stocks.

B. Private Business Ownership Interests:

dividend, and a liquidation preference. Section 2701 acts to depress the value of the retained preferred stock, thus in effect increasing the value of the common stock for gift tax purposes.

Unlike stocks or securities of publicly-traded companies, ownership or income interests in closely-held corporations or in partnerships cannot be transferred to children, for tax purposes , particularly minor children, without substantial difficulty. The basic problem is the overriding perception of Aparental control@. When a parent has a controlling interest in a private business, a gift of some part of her ownership interest to children is a transfer of property and not a mere assignment of income. The only characteristic which distinguishes this type of capital investment from publicly-traded stocks is the active involvement (normally) of the parent in the operations of the business.[34] For example, if the parent (or grandparent) has a hardware business worth $5,000,000 and would like to irrevocably transfer 20% or $1,000,000 of that business to his four children, some of whom are under the age of majority, but over 14 years of age, the income and wealth transfer tax consequences depend on the parent=s success in avoiding some difficult obstacles.

[34]The estate tax provides some valuation relief for certain farms and closely held businesses. I.R.C. Sections 2032A. But apart from the problems in complying with these incentives, the provisions have limited fiscal application because of the small number of estates that are required to pay a death tax.

Assume the business is conducted in corporate form, with the parent owning all the capital stock, and that its annual taxable income is $200,000. For income tax purposes the corporation is a separate legal entity, paying a corporate level tax on its taxable income. If the children are still under the age of majority, title to the stock should be in the name of an entity or person independent of the parent. Otherwise, the IRS could take the position that the parent is the *de facto* owner of the stock and any distribution of dividends remains taxable to the parent.[35] Transferring the stock to a custodian account under one of the Uniform Transfer to Minors Acts may be theoretically possible in some states so long as the parent is not the custodian. While there is a legal separation of ownership of the stock, there are practical restraints, such as the right of the custodian to vote the stock and to potentially interfere with management of the corporation. In addition, when the children reach majority the custodianship must terminate. If they are away at college, for example, or if the stock is transferred to a trust, the trustee (also best required to be independent of the parent) would normally distribute trust income to the children to avoid being taxed at the highest rate on any accumulated trust income over $9,550 (in 2004) .[36] Moreover, the trust arrangement may be cumbersome and interfere with the

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[35] If any portion of the corporate profit is in reality attributable to services of the parent the distribution of that portion to the children could be argued to be a violation of the Earl case. If the corporation is an AS@ corporation (where income and loss is passed through and taxed at the shareholder level), I.R.C. §1366(e) requires that the corporate profit must be first reduced by the Areasonable compensation@ of the controlling shareholder (the parent, usually), and thus taxed to the parent-assignor, before the remaining profit is allocated to the other shareholders . Similar rules obtain for family partnerships. I.R.C. ' 704(e). It could also be determined that the dividends are in reality payment of the parent=s obligation of support and thus taxed to the parent. I.R.C. ' 677(b).

[36] I.R.C. Sec. 1(e).

customary operation of the business.

The gift tax consequences to the parent may be governed by the special valuation rules applicable to retained interests[37], possibly *increasing* the value of stock transferred to the children. In a closely-held corporation there is also the problem of assigning a value to the business which is not traded in a public market.

C. Services Businesses:

In this part I will discuss the prohibition on parental shifting of income to their children where the income is derived from services. As noted in Part II, the Earl doctrine- banning assignment of income[38] from services- does not preclude the shifting of other types of income, such as dividends, interest, rent, unrealized gains, and other income from capital investment, by transferring a Avertical slice@ of a portion of the property itself.

[37] I.R.C. Sec. 2701. See *supra* note 33.

[38] *Supra* notes 10-13 and accompanying text.

The most contentious problem in prohibiting income-splitting of services is where the taxpayer=s income is derived from a combination of both personal services and capital. The IRS and Treasury Department have tried to deal with this problem in other tax law contexts, but generally without success. The attempted solution is to treat no more than 30% of the net profit as compensation for Aservices@, the remainder deemed as income derived from Acapital@.[39] For example, if a doctor were a partner in a diagnostic clinic which has invested substantial capital in MRI and other radiological equipment, the doctor could assign some part of her income from the clinic to her children, provided she could ascertain what portion of her income was from services and what portion from capital. No easy task for her or the Internal Revenue Service. Likewise, a taxpayer whose business involved the development of computer software would have the same problem.[40] The issue is becoming more pervasive as we move to an economy where historically based distinctions are blended out of the system. The tax law will be forced to adapt to these changes if only to be consistent in its treatment of taxpayers who are substantively the same.

As our economy takes on more of a high technology profile, inventions, computer software, and other intellectual property, as well as the more conventional types of business activity, such

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[39]See, for example, Treas. Reg. ' 1.911-2(b)(2)(1985), dealing with the foreign earned income exclusion. The 30% rule was found earlier in the now repealed 50% maximum tax on Aearned income@(services), where other income was taxed at 70%. I.R.C. 1348; Michael Asimow, *Section 1348, The Death of Mickey Mouse*, 58 Cal. L. Rev. 801, 835-860 (1970). (discussing the dual rate structure.)

[40]For an illustration of how courts struggle with this issue, see Siegel v. United States, 464 F.2d 891 (9th Cir. 1972).

as auto body shops, film production, plumbing contracting, and embalming, represent income produced with both labor and capital mixed together.[41]

One could argue that the rationale for treating services more harshly is that they have not yet been taxed and that the earner of those services should be the one who is taxed. Or one might argue that the tax law encourages capital investment recognizing the risk-taking aspect. However, both of these arguments have nothing to do with the income-splitting issue, where , for example, the dividends and the unrealized appreciation on stocks will not be taxed to the parent who owned the stock while it was appreciating in value. In fact, the services, even if allowed to be assigned, would be taxed in the current tax period, whereas the transfer of unrealized gain might not be taxed for several years, if ever.

[41]This issue is discussed with illustrations in Snyder, *Taxation with an Attitude, supra* note 10.

The courts and the IRS have had considerable difficulty in coming up with a consistent standard in cases involving assignment of services income. Patent and copyright cases are illustrative. Where the taxpayer obtains a patent and assigns the patent to a family member, even though the taxpayer invented the item with her own efforts, it is assumed by the courts that the royalties are taxed to the family member since the taxpayer retained no interest in the patent itself.[42] But where the taxpayer-inventor assigns the rights to a copyright or a patent created with her own efforts and retains some contractual rights (such as the right to bargain with the manufacturer for the fixing of future royalties), there is some possibility that the assignment would be deemed incomplete, leaving the royalties to be taxed to the assignor-parent.[43] It is difficult to predict the outcome of many cases where one small change in the facts will change the result from a transfer of Aservices@ income to a transfer of Aproperty@.

IV. A Few Proposed Solutions:

The present state of the tax law on income-splitting with minor and adult children sanctions

[42]Rev. Rul. 54-599, 1954-2 C.B. 52. But cf. Commissioner v. Sunnen, 333 .U.S 591 (1948), holding that the taxpayer-assignor retained too much control over the assigned patent and therefore remained taxable on the royalties.

[43]*Cf.*, for example, Heim v. Fitzpatrick, 262 F.2d 887 (2d Cir. 1959) (holding that the royalty payments assigned consisted of both property and income rights and thus were valid assignments taxable to the donees); and Strauss v. Commissioner, 168 F.2d 441 (2d Cir. 1948) (holding that assignment of royalties from a personal services contract were taxed to the donor who rendered the services).

an inconsistent treatment of gifts of income to children of passive investors (mainly in publicly-traded stocks) as compared to children of active earners and private business owners. I question those who conclude that income-splitting is not as prevalent today. They attribute this to a compression of income tax rates on trusts- so that accumulated income of trusts in excess of $9,550 (for 2004) is taxed at the highest marginal rate of 35 %[44]- and to the fact that children of wealthy parents are often in higher income tax brackets to begin with. There is no available hard data on this.[45] In any event there is no justification for allowing greater opportunity for income-splitting for one class of taxpayers over others. There is also no data on the extent of any revenue loss to the Treasury.

Other commentators take a broader look at the issue by examining parent/children taxpayer profiles and econometric data to determine the impact of these income-splitting rules and other laws on future generations of children.[46]

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[44]I.R.C. Section 1(e). *Supra* note 25.

[45]See the illustrative case on mother=s gift of public stock, *supra* note 18 and accompanying text.

[46]See, for example, David Joulfaian, The Federal Estate and Gift Tax: Description, Profile of

Taxpayers, and Economic Consequences, OTA Paper 80 (December 1998); Allan J. Samansky, Tax Policy and the Obligation To Support Children, 57 OHIO ST. L.J. 329 (1996); Anne Alstott response to Samansky, "Tax Policy and the Obligation to Support Children",57 OHIO ST. L.J. 381 (1996).

Lack of uniformity and incomplete data make it imperative that we explore alternative ways to deal with these income-splitting issues. One plausible solution would be to flatten the income tax rate structure and permanently repeal the wealth transfer taxes. In addition to the fact that the wealth taxes produce only around 1% of our total federal tax revenue, the strongest case for repeal, here again, is that some wealthy taxpayers escape the tax while others cannot, either because of the nature of their income-producing activity or because of astute estate planning advice, or both.[47] However, it is probably unrealistic to explore this flat-rate alternative at this time in the context of the present income tax structure.

[47] An often advertised scheme shows how multimillionaires with liquid and passive investments make use of the life insurance exclusion from both income and estate taxes to enhance the size of their estate, compared to those taxpayers who are actively involved in their private businesses, which usually have less ready cash for the one-time insurance premium necessary to engage in the life insurance scheme.

The consumption tax proposals introduced in Congress in the mid-1990's, such as the AFlat Tax@[48], would have (1) adopted a single, flat-rate structure, (2) generally taxed all businesses alike (whether income was produced from capital investment or services), and (3) eliminated any need for a ban on Aassignment of income@. While the recent rate reductions on dividend and capital gain income[49], may be viewed as a step in the direction of a consumption type tax, where savings are treated more favorably, there is no indication that Congress is ready for such a major change in the current tax system.[50]

Another alternative is to do away with artificial tax law distinctions involving Aparental control@, and abolishing the increasingly difficult distinction between income from services and income from capital. While theoretically correct, this also might be a more pervasive proposal requiring more extensive analysis beyond the higher education issue discussed in this paper.

To eliminate discrimination, I suggest as a starting point, consideration of a two-pronged

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[48] H.R. 2060, 104th Cong., 1st Sess. (1995).

[49] See *supra* note 4.

[50] For a few examples of the advantages and disadvantages of a consumption-type tax, see William D. Andrews, *A Consumption-Type or Cash-Flow Personal Income Tax*, 87 HARV. L. REV. 1113 (1974); Alvin C. Warren, *Would a Consumption Tax Be Fairer Than An Income Tax*, 89 YALE L.J. 1081 (1980); Lester B. Snyder and Marianne Gallegos, *Redefining The Role of the Federal Income Tax: Taking the Tax Law APrivate@ Through the Flat Tax and Other Consumption Taxes@*, 13 AM. J. TAX POLICY 1 (1996), and Lester B. Snyder & Roger J. Higgins, *Evaluating the Consumption Tax Proposals: Changes in the Taxation of Interspousal Transactions, Use of Trusts, and Revising The Meaning of A Tax Planning@*, 33 SAN DIEGO L.

short-term (perhaps 5 years) proposal:

1. Taxpayers with minor children, or perhaps grandchildren, could elect to shift a percentage of their income (whether active or passive, whether from public or private business, including wages or other services income) to his/her minor children or grandchildren through a specially defined (by federal tax law) uniform custodial account.

REV. 1485 (1996).

A tax credit would presumably be more equitable than a tax deduction, so that all taxpayers no matter what marginal rate bracket they are in, would be included. The credit could be refundable, so that individuals with minimal or no tax liability could receive some benefit as well. There are a variety of ways to craft the credit. For example, one model could allow a credit equal to a percentage of taxable income, starting with, say, 5% for taxpayers with under $100,000 of taxable income and scaled down from 5% to 1% for those over $100,000. The credit could be limited to one child (under 17 years of age) per year so that taxpayers would be able to rotate the credit to help set aside funds to finance their children's college education as each child reaches college age.[51] More flexibility could be achieved by allowing an election

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[51] An alternative method could be similar to the current child credit, which provides for an annual credit of $700 (increasing to $1,000 in 2010) *per child*, without the $110,000 of adjusted gross income threshold limitation ($75,000 for single parents)). I.R.C. § 24. However, my proposal anticipates a higher tax benefit tied to financing higher education for one child (possibly two) each year. The child credit and complicated education credits (I.R.C. §§ 25A and 25B), which are nonrefundable credits, can be replaced with the broader based credit I am proposing. Although the thrust of this article is policy oriented and thus not based on revenue costs or estimates, one gets a sense of the extent of the child and education credits by looking at the data in the Internal Revenue Service Statistics of Income Bulletin Winter 2003-2004, Washington, D.C. for individual tax returns for the year 2002. Approximately 26 million taxpayers (about 20% of all taxpayers) took advantage of the child credit, for a total amount of $21.5 billion, and only 6.5 million returns (about 5% of all taxpayers) took the education credits amounting to $4.9 billion. SOI Bulletin, cited above, at page 15. The total revenue cost of these two credits, about $26.5 billion could be replaced with the proposal suggested by increasing the higher education credit to, say, $40 billion to $50 billion thus eliminating the present bias against the majority of children. Assuming a 5% of taxable income credit, the total revenue cost would depend on the number of children (using under 17 years of age as the age cap) for all taxpayers. If we use the child credit numbers for 2002, only 20% of all taxpayers availed themselves of that credit. But, assuming that the 20% figure is lower than the actual number of taxpayers with children, were we to increase the number to 25%, somewhere around $ 1 trillion (25% of the $4 trillion shown in the 2002 Statistics of Income) would be the base figure of taxable income of taxpayers with children. A 5% credit on taxable income results in about $50 billion in revenue cost to the government. The distribution effect among income class (by size of taxable income) would depend on a number of factors, but by

between parent and grandparent as to which one takes the credit in a particular year.

In addition, a significant portion of the non-tax direct grant expenditures could be replaced by the refundable tax credit, proposed herein. Any additional revenue cost to make up any difference, if there is one, would be a relatively small cost in return for the substantial benefits that would be utilized by a broader group of children for their college education than is the case under current laws.[52]

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scaling the credit downward for the upper income taxpayers, the higher education tax incentives for all taxpayers would be far more equitable than under current tax law.

[52] The proposal suggested in this article is more equitable than the recent Treasury Department proposal for tax-exempt ALifetime Savings Accounts@ (allowing contributions of $7,500 a year, with capital gains, dividends, and certain interest earned in the accounts treated as tax-free) This is arguably more expensive, more damaging to existing pension/retirement plans, may jeopardize savings bank accounts, and may have little impact on low-income Americans. See, letter from Frank Keating of the American Council of Life Insurers, AInsurance Group Wary of Lifetime Savings Accounts Plan@, published in 2004 TNT 23-53, February 4, 2004. Also see, Article in Washington Post, May 24, 2004, Section A04, AWall Street Firms Funnel Millions To Bush: Finance Sector Produces Surge of Cash to President Who Cut Taxes on Dividends, Gains@, Byline: Thomas B. Edsall and Jonathan Weisman.

This is a complete about-face from current law. Instead of looking at income-splitting as an evil concept, this proposal would regard it as a positive approach which should be strongly encouraged.

2. In order to collect data on the extent and nature of income splitting in this country, we would require all those who elect to take the new education credit as described in (1) above, to file an information return, similar to a Form 1099 , but expanded to include the details of the uniform custodial account contributions. In addition to the collection of data for evaluation purposes, the information returns would be available to the child or his/her custodian and would serve to protect the child=s interest, and thus serve as a response to current law concepts of parental control.

V. Conclusion:

Our graduate income tax structure provides an incentive to split income with lower-bracket family members. However, transferring income to children has been treated inconsistently and unfairly in the federal income and wealth transfer tax laws. Some parents have much more latitude to shift income to their children than do others. Parents who own publicly-traded securities are the most favored species; those who derive their income from services and private business are least favored. The rationale given for treating gifts of private business interests to children less favorably is that the parent has not parted with control of the property.

The parental control test eludes gifts of shares of a parent=s publicly-traded securities.

Tax lawyers and tax academics, unfortunately, appear to condemn income-splitting in its most obvious form, but condone it in less obvious methodologies, such as gift/leasebacks, use of family limited partnerships, private annuities and other tax-avoidance arrangements.

One proposed solution to this lack of uniformity, is a two-pronged structure: (1)A new refundable tax credit election by parents (or grandparents) with minor children, for amounts placed in a federally defined uniform custodial account, to be set aside for higher education costs for those children; and (2) A manageable information reporting and accounting system. This would provide us with reliable data on the extent of income earmarked for higher education. It would also do away with the outdated assignment-of-income doctrine in the area of education. The reporting would also make some information available to the childrens= custodians to assure the children that they are entitled to retain the income or property they were taxed on. At the same time it would neutralize the parental control factor which has driven so much of the tax law in this area.
