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

LESTER B. SNYDER*

TABLE OF CONTENTS

I. INTRODUCTION ........................................................................................................... 1312
II. ORIGINS OF THE BAN ON INCOME SPLITTING: LUCAS v. EARL AND ITS PROGENY IN THE AMERICAN TAX SYSTEM ............................................................... 1314
III. INCOME-SHIFTING IN THREE CONTEXTS ............................................................ 1319
   A. Publicly-Traded Stocks and Securities .................................................................. 1319
   B. Private Business Ownership Interests ................................................................. 1323
   C. Services Businesses ........................................................................................... 1326
IV. SOME OTHER ATTEMPTS AT INCOME SPLITTING ................................................. 1328
   A. Gift and Leaseback: “Tax Avoidance or a Legitimate Business Transaction”? .... 1328
   B. Family Limited Partnerships ............................................................................. 1330
V. A FEW PROPOSED SOLUTIONS ............................................................................. 1331
VI. CONCLUSION ......................................................................................................... 1334

* Professor of Law, University of San Diego. My thanks to Lyn Snyder for her editorial comments and to Sheila M. Eckert for her research assistance on this Article.
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 “passive” 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 “active” 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, but they are generally limited to taxpayers with income under $100,000. However, for a variety of reasons (some

1. Data on the subject of tax benefits for higher education is as yet not complete. What limited data is available indicates that there was an estimated $13.9 billion in direct grants (for 2001–2002) and an estimated $44.1 billion in student loans and work-study money (for 2001–2002) available for students in higher education. The College Board, Trends in Student Aid, 2003, at tbl. 2 (updated Oct. 27, 2003), available at www.collegeboard.com. 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 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. Excerpt from Estimates of Federal Tax Expenditures for Fiscal Years 2000–2006, Staff of the Joint Committee on Taxation, Jan. 17, 2002, in MICHAEL J. GRAETZ & DEBORAH H. SCHENK, FEDERAL INCOME TAXATION: PRINCIPLES AND POLICIES 39–42 (rev. 4th ed. 2002). The Joint Committee on Taxation, Present Law and Analyses Relating to Tax Benefits for Higher Education (JCX-52-04), July 21, 2004, summarizes the various current tax benefits for higher education expenses. This data is also published in 2004 TAX NOTES TODAY. JCT Describes Tax Benefits for Higher Education Expenses, Tax Notes Today, July 22, 2004, available in LEXIS, at 2004 TNT 141–18. The JCT estimates total government 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 (JCX-8-03), Dec. 22, 2003, at 25.

2. I.R.C. § 529 state tuition plans are available to taxpayers with higher incomes, but they can only be funded 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 78 (CCH Incorporated 2003), stating that "parents may wish to reconsider the use of other tax-
known and some not) these tax credits, exclusions, and deductions are utilized by a small minority of taxpayers and their children. In fact, the most significant tax benefits for higher education have been in the Internal Revenue Code for several years, but are subtly buried in the structure of the tax law as a whole.

A recent example demonstrates how this indirect preferential subsidy works. The 2003 Tax Act 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. 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 dividend and capital gain income) than all specific education tax credits combined.

We need to explore here some of these broader tax benefits which have favored some 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 byproduct 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 favored savings vehicles such as [I.R.C. § 529] plans and Coverdell Education Savings Accounts.”

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.

After briefly exploring the historical origins of the prohibitions on so-called “income splitting,” and some of their statutory exceptions, the Article 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 personal services and actively operated businesses.

The Article then explores a few alternatives to resolve this discrimination, with a view towards 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 patch quilt of complex and incoherent tax incentives.6

II. ORIGINS OF THE BAN ON INCOME SPLITTING: LUCAS V. EARL AND ITS PROGENY IN THE AMERICAN TAX SYSTEM

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.7 Because we do not

6. 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 V. 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, create a significant new opportunity for those taxpayers with income from these passive investment sources to shift income to children.

7. Income shifting is quite pervasive, outside the family or transfer to children context, in private businesses, such as partnerships and limited liability companies and “S” corporations, where the pass-through or conduit structure inherently allows it. The Congressional attempts to curb income (or deduction) shifting that have “no substantial economic effect” (I.R.C. § 704(b) (2004)) 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 or loss wherever it will produce the lowest overall tax burden.
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.

The overriding concern against shifting one’s income to another person is a 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. What tax policy objective is accomplished by bestowing more favorable tax-savings options upon passive investors of capital than upon the rest of the tax-paying public? The question will be explored in Parts III and IV.

While the Internal Revenue Code did not originally expressly prohibit shifting or assigning income, over seventy 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 contract by a husband and wife to divide their respective incomes equally. 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. Nevertheless, the Earl opinion has had a profound impact in creating the so-called “assignment of income” doctrine that has been applied in a wide variety of tax cases. While

8. 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 “warp” and “woof” 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 both 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.


11. The theory advanced by Holmes is based on the following quoted phrase from the Earl opinion:

[This 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
Congress later expressly reversed *Earl* in 1948, when it enacted the joint return allowing income splitting among spouses, the assignment of income remains in full force for nonspousal income splitting cases, particularly as it applies to transfers of income to children (whether minors or adults) and other family members.

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

> 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.12

In other words, a partial transfer of a few shares of stock would suffice to shift the income from those shares.13 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*.

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

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13. 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*. 

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1316
(IRS), resulting in more costly financial and legal planning with a high probability of litigation.

Allowing wage earners and portfolio investors equal access to income splitting with their children would change the eighty-year-old judicially created doctrine, which has outlived its usefulness, and runs counter to the contemporary wishes of most of our citizens. The proposals suggested in Part V 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.14

This Article argues for a more harmonized or uniformly consistent treatment of income splitting with children. Uniformity is often viewed either as an unattainable theoretical ideal or on a more mundane level as a way, in effect, to reduce the choices for tax planning. While the tax law is hardly a model of uniformity in its treatment of tax burdens and benefits, uniformity is a fundamental principle of American jurisprudence as found, for example, in the equal protection and due process clauses of our Constitution. Uniformity, or “logical consistency,” is a concept discussed in respected nontax scholarship.15

One major rationale for the generic ban on income splitting with minor children under current tax law is the theory of “parental 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

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14. 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 V could be in the form of a refundable tax credit (similar to the earned income tax credit in I.R.C. § 32 (2004)). By folding in some of the nontax subsidies with the proposed tax credit, the revenue impact may be far less onerous on the federal government.


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 accepted methods are more often than not substantively equivalent to other methods which are verboten. With careful 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.

This creates a disparity in power and wealth between children of passive investors and children of active earners and private businesses. The larger issue is, which children in future generations will have more power and influence? The fact that all children may eventually inherit their parent’s wealth is besides the point, where the tax laws leave more to the favored income and wealth assignee. As will become evident throughout this Article, the issues discussed are for the most part applicable under present law to high-middle income and high income taxpayers, some of whom have more options to shift income and wealth to their children than others in their same income class. The proposal discussed in Part V would not only treat all high income taxpayers alike, but more significantly would introduce an incentive for all classes of taxpayers to shift a percentage of their income to their children. This is a more positive approach, not penalizing owners of publicly traded stock or upper income taxpayers, but including them alongside other parents in starting a new approach. The revenue required to fund this proposal can come from replacing in part some of the current less effective and discriminatory tax benefits purportedly aimed at education. A comparative analysis of current and recently enacted education incentives would show how incomplete and insignificant these benefits are when compared to the proposal advanced in this paper.

This Article does not deal directly with the ongoing debates on

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17. See infra note 29, for reference to Congressional attempt to curtail use of trusts for income splitting purposes by compressing the rates for trusts which accumulate (as distinguished from those that distribute) income to the minors’ guardians or custodians. I.R.C. § 1(e). Taxable income over $9550 was taxed at the 35% rate bracket in 2004 (the bracket is indexed for inflation each year).

18. For an interesting look at parent-child profiles and econometric data to determine the impact of income splitting and other rules on future generations of children, see articles infra note 74. While these articles analyze important distributional issues, such as what classes of taxpayers give to children during life, this Article attempts to go beyond that by questioning the differences between parents with different types of assets and sources of income.
whether the wealth transfer taxes should be permanently repealed, and
the related suggestions of imposing an income tax on gifts and bequests.
However, I argue in Part III that the recently “now you see it, now you
don’t” repeal of the wealth transfer taxes19 would have resulted in a
significant simplification of the potpourri of income-shifting rules and
brought some uniformity of tax burden to taxpayers with different types
of assets. But the recent tax legislation will instead make gift and estate
planning a more complex task than before, and will further my argument
for the proposals advanced in this Article.20

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, but with the highest probability of tax savings to the
transferor-donor during her lifetime.21 Consider the following example:
Mother owns (among her many other assets) 10,000 shares of G, Inc.
stock (publicly traded), which she purchased several years ago for $10
per share or $100,000. The stock, which is now trading at $100 per
share (thus having a total fair market value of $1,000,000), has been
paying regular annual dividends to Mother of $8 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%,22 although her tax liability in years before 2003 and after 2008

20. A proposal by Professors Shakow and Shuldiner for a low, flat rate
    “comprehensive wealth tax” would offer a more equitable solution to the problems in the
    current regime, even with some inevitable valuation problems. David Shakow & Reed
    S. Knoll, Of Fruit and Trees: The Relationship Between Income and Wealth Taxes, 53
    TAX L. REV. 587 (2000); James R. Repetti, It’s All About Valuation, 53 TAX L. REV. 607
    (2000). For evaluation of alternative tax systems see John B. Shoven & Paul Taubman,
    Saving, Capital Income, and Taxation, in THE ECONOMICS OF TAXATION 203, 203–04
    (Henry J. Aaron & Michael J. Boskin eds., 1980).
21. Publicly traded securities would include other investments, such as certain
    options, financial derivatives, some mutual funds, and some 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.
22. State and local income taxes have been disregarded throughout this Article, but
would be around $28,000, assuming a maximum rate for those years of
35%. Since dividends and capital gains can be taxed at as low as 5%
from 2003 to 2008, even with the “temporary” 15% rate, a parent can
save another 10% ($8000) per year by shifting some stocks to her
children. Assume Mother is fifty years old, widowed, and has four
children, ranging in ages from fifteen to twenty-one. Her other stocks
and assets are estimated to be worth $5,000,000.

Mother decides to give each of her four children $250,000 worth of G,
Inc. stock, all in one year or over four to five years. 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 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.

The simplest method is to transfer the stock to a custodianship account
for each child under twenty-one, pursuant to the Uniform Transfer to
Minors Act, which has been adopted in one form or another in all
states. The custodian, who should be a third person or financial
institution, is empowered to accumulate the income until the child
reaches twenty-one, 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. Assuming the
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 25%–30%. California’s highest income tax rate is 9.3%.
CAL. REV. & TAX CODE § 17041(a) (West 2004); New York’s highest state income tax
rate is 7.7%, with another 2% for the New York City residents. N.Y. TAX LAW § 601
(Consol. 2004); N.Y. GEN. CITY LAW § 3 (Consol. 2004).

23. See supra note 4 and accompanying text.
24. The new 5% rate for dividends and capital gains applies to those in the regular
10%–15% lower income tax bracket. Thus, a child with under $28,400 (the 2003 rate
bracket) of taxable income is taxed at 5% on dividends and capital gains. I.R.C. §§
25. 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.
27. The Commissioners on Uniform State Laws have promulgated such acts. The
Acts vary somewhat from state to state. See, e.g., California Uniform Transfers to
Minors Act, CAL. PROB. CODE § 3900 et seq. (West 2004).
28. This is most often the case even though the age of majority in a particular state
may be under twenty-one.
29. 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%)
is reached at around $9550. See infra note 41 and accompanying text. However, trust
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 $4000 per year (5% x $80,000), or $8000 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
fourteen years of age, the children avoid the so-called “Kiddie Tax”
which taxes “unearned” income, such as the dividends in this case, at the
parent’s higher rate bracket. In years prior to 2003 and after 2008
(assuming Congress 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) 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 time value of money works to the family’s
advantage where the deferral of a “realized” 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.

The bigger point, however, is that the 2003 rate reduction on
dividends and capital gains will generally favor those with publicly
traded stocks, giving that class of taxpayers more net cash to pay their
children’s higher education costs.

Because 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

income which is distributed to a beneficiary is taxed at the normal rate schedule. I.R.C.
§ 1(e); cf. id. § 677(b), which taxes a grantor on income of a trust used to satisfy a
grantor’s obligation of support.
30. Id. § 1(g). The child’s income tax liability may be further reduced by the
standard deduction. Id. § 63(c). Where the child is under age fourteen, the Kiddie Tax
can be avoided by transferring low-yield stock, which is expected to increase in value
after age fourteen.
31. Id. § 1015(a).
for the child. The more elaborate trust structure is unnecessary for this type of property unless the parent wishes to curtail the use of the income by the child after age twenty-one. 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 $1,000,000 of wealth, increasing to $3,500,000 by 2009, after which it sunsets in 2010, and reappears in 2011 restoring pre-2001 levels of tax. In addition, a donor may exclude $10,000 per year per donee (20,000 if her spouse consents), provided the gift constitutes a “present interest” in the property to the donee. Gifts to minors qualify as present interests even though held in an accumulation account by a custodian.

With respect to the gift tax annual exclusion, a recent case illustrates how a gift of interests by parents to their children in a family tree farm business, in the form of a Limited Liability Company, did not qualify for the annual gift tax exclusion. The court determined that the donor parents retained control over the interests transferred. Unlike ownership shares in a public or large 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.

Taxpayers who have exhausted their $1,000,000 lifetime credit are

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32. 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 “backstop,” 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.

33. I.R.C. § 2503(b). The exclusion is increased by a cost-of-living adjustment, currently $1000. Thus, with spousal consent, the amounts are increased from $11,000 to $22,000. Id. § 2503(b)(2).

34. Income from property transferred to a trust for the benefit of a minor can also qualify as a present interest for the gift tax annual exclusion even though the trust accumulates the income until the child reaches age twenty-one. However, as mentioned above, the accumulated income is taxed at the higher marginal rates for income tax purposes. One would then weigh the gift/estate tax savings against the higher income tax rates (but no higher than the donor’s rates).

35. Hackl v. Commissioner, 335 F.3d 664, 665–68 (7th Cir. 2003).
also able to avoid gift tax liability entirely by paying tuition to an educational organization on behalf of any individual.\textsuperscript{36}

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.\textsuperscript{37} Legislation enacted in 1990 in effect increases the value of the transferred interest and thus the gift tax paid by the donor.\textsuperscript{38} This section is generally not applied to publicly traded stocks.

\textbf{B. Private Business Ownership Interests}

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 parental 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

\begin{footnotesize}
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\item \textsuperscript{36} I.R.C. § 2503(e)(2)(A). This exclusion is not restricted by the normal $10,000/$20,000 annual exclusion in § 2503(b) and thus does not come within the present interest requirement. Thus, a taxpayer with minor children or grandchildren can pay all their college tuition, without gift tax liability. In this instance, we are talking about wealthier taxpayers who are affected by the gift tax, some of whom derive their income from nonpublicly held securities or even from services. However, the largest segment of wealth transfer taxpayers are more likely than not in the public securities category, for reasons discussed above. Services taxpayers, however, can pay the tuition only with after-income tax dollars.
\item \textsuperscript{37} \textit{See infra} note 38.
\item \textsuperscript{38} 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 ed. 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 “estate freeze” technique. I.R.C. § 2701. The parent gifts the common stock to her children, and retains preferred stock with voting control, an annual 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. \textit{Id.}
\end{itemize}
\end{footnotesize}
(normally) of the parent in the operations of the business. 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 fourteen years of age, the income and wealth transfer tax consequences depend on the parent’s success in avoiding some difficult obstacles.

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. 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. Moreover, the trust arrangement may be cumbersome and interfere with the customary operation of the business.

The gift tax consequences to the parent may be governed by the

39. The estate tax provides some valuation relief for certain farms and closely held businesses. I.R.C. § 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.
40. 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 “S” corporation (where income and loss is passed through and taxed at the shareholder level), section 1366(e) of the Internal Revenue Code requires that the corporate profit must be first reduced by the “reasonable 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. I.R.C. § 1366(e). Similar rules apply to family partnerships. Id. § 704(e). It could also be determined that the dividends are in reality payment of the parent’s obligation of support and thus be taxed to the parent. Id. § 677(b).
41. Id. § 1(e). This is the dollar amount for 2004, adjusted for inflation each year, based on changes in the Consumer Price Index. See Revenue Proc. 2003–85, § 3, 2003–49 I.R.B. 1184.
special valuation rules applicable to retained interests, 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.

The uncertainties associated with transfers of corporate stock in private companies leads us into a brief discussion of the use of trusts, and three pass-through entities—the “S” corporation, partnerships, and limited liability companies—as potential avenues for income splitting with children. Some of these are aimed primarily at reducing the wealth transfer tax burden—in other words, to keep the transferred interests out of the transferors’ or parents’ estates. While discussion of each of these methods is beyond the scope of this Article, a very general overview may be helpful in assessing their effectiveness and efficiency.

Historically, the use of trusts was the most efficient way to accomplish income splitting with children. However, Congress’s concern (perhaps obsession) with avoidance of the graduated income tax rate structure led it, in 1993, to compress the tax rates on income accumulated in trusts. Income splitting with children in lower tax brackets could then be better accomplished by regular partnerships, S corporations, and family limited partnerships, where the business income (or loss) is passed through to each partner or shareholder whether or not distributed to these owners. At the same time, the emergence of another state-created entity—the “limited liability company,” taxed as a partnership in most cases—offers another option for avoiding double tax on corporate profits, while retaining limited liability protection.

As for the use of a partnership to operate a business, the parent could start a new business and transfer some assets to her children who could then become co-transferors of those assets to a new partnership.

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42. See I.R.C. § 2701 and supra note 38.
45. Id. §§ 1361–1363.
46. For discussion of family limited partnerships see infra note 67 and accompanying text.
48. If the parent operated her existing business in corporate form, there would be a potential two-level tax on liquidation distributions. I.R.C. §§ 331, 336. The corporation could elect S corporation status without a tax, but the conditions for S corporation status are cumbersome.
49. Sections 721 and 722 allow transfers of appreciated property (not services) to
However, the issue of parental control may prevent the successful implementation of this plan. If the partnership income is generated by services of the parent-donor, or by a combination of services and capital, the profits cannot be divided among partners without first allocating a reasonable compensation for the parent, effectively prohibiting an allocation or shifting of at least a portion of the income to the childrendonees of the partnership interest. The same is true for S Corporations.

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 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 “vertical slice” of a portion of the property itself.

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 services, the remainder deemed as income derived from capital. 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 IRS. Likewise, a taxpayer whose business involved the development of computer software would have the same problem. The issue is becoming more pervasive as we move to an economy where historically based distinctions are blended.

be transferred into a partnership without income taxation. The partnership retains the same tax basis for these assets as the transferors’ bases. Id. §§ 721–722.

50. Id. § 704(c)(2).
51. Id. § 1366(e).
52. Supra notes 9–16 and accompanying text.
53. See Snyder, supra note 9.
54. See, e.g., 26 C.F.R. § 1.911-2(c)(2) (2002), dealing with the foreign earned income exclusion. The 30% rule was found earlier in the now repealed 50% maximum tax on “earned 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, 835–60 (1970) (discussing the dual rate structure).
55. For an illustration of how courts struggle with this issue, see Siegel v. United States, 464 F.2d 891 (9th Cir. 1972).
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 as auto body shops, film production, plumbing contracting, and embalming, represent income produced with both labor and capital mixed together.56

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. Moreover, it is difficult to see how the risk taking issue has a direct tax policy connection to the income splitting issue.

The courts and the IRS have had considerable difficulty in coming up with a consistent standard in cases involving assignment of services income.57 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.58 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.59 It

56. This issue is discussed with illustrations in Snyder, supra note 9.
57. See Snyder, supra note 9.
59. Cf. Heim v. Fitzpatrick, 262 F.2d 887 (2d Cir. 1959) (holding that the royalty payments assigned both property and income rights and thus were valid assignments taxable to the donees); Strauss v. Commissioner, 168 F.2d 441 (2d Cir. 1948) (holding
is difficult to predict the outcome of many cases where one small change in the facts will change the result from a transfer of services income to a transfer of property.

The results are just as murky in cases involving professional services. In one case, a taxpayer, a lawyer, rendered services for Firm A, then left Firm A and became a partner in Firm B. He received fees for services he rendered while at Firm A after he joined Firm B and paid these fees over to Firm B. Even though the taxpayer rendered these services, the court held that he was not taxable on the fees collected by Firm B. The same result should occur if the lawyer were to assign his services income to his family, yet, in another case, a dentist assigned his “lifetime services” to a family trust he created. The trust agreed to manage the dentist’s practice for a percentage of his income. The court held the assignment invalid and taxed the dentist on the entire income of the practice.61

As indicated earlier, the prohibition against assignment of income from services can also be found in the Internal Revenue Code. Congress has incorporated the Earl doctrine into the family business context in two pass-through entities, partnerships and S corporations. Section 704(e)(2) requires the donor (such as a parent) of a gift of a partnership interest to be taxed on the value of her services before the remaining partnership profit is allocated and taxed to the partners (including the children of the donor). The effect of this provision is to allow income splitting for nonservices income, but not for that portion of the income which is deemed to be services rendered by the donor. The same concept is applicable to an S corporation.63

IV. SOME OTHER ATTEMPTS AT INCOME SPLITTING

A. Gift and Leaseback: “Tax Avoidance or a Legitimate Business Transaction”?

Consider the case of a medical doctor who owns no publicly traded stocks to transfer to his children, but instead transfers his medical office building or his medical equipment or both to an irrevocable trust for the benefit of his children, naming his attorney or accountant as trustee. The doctor will then lease back the building or equipment from the trust for a

61. Pfleguer v. Commissioner, 840 F.2d 1379 (7th Cir. 1988). Of course, it did not help the taxpayer that he actually was a “tax protester.” Id. at 1386.
62. See supra note 40 and accompanying text.
fair rental price, deducting the rent paid to the trust as an ordinary and necessary business expense. If successful, the doctor has in effect shifted an amount of income equal to the rent paid, which is deducted against his other income.64

The federal courts are divided on the legitimacy of this type of transaction. The main issue is whether the rent paid is deductible as a business expense under Internal Revenue Code section 162(a)(3), which restricts the deduction where the lessee-doctor has an ownership or equity interest in the leased property. The IRS generally balks at these family leasebacks as disguised income-shifting schemes, requiring the taxpayers to litigate in the courts. In one case, the Second Circuit Court of Appeals allowed the deduction even though there was no strong business purpose for the transaction, noting that there was a change in economic interests of the parties resulting in no legally retained equity interest by the lessee doctor.65 However, other Circuits have upheld the government’s position.66

Because the IRS is likely to scrutinize most of these transactions, taxpayers must be prepared to structure the gift-leaseback, paying careful attention to the economic details. Here again, we see the concept of parental control utilized to challenge semipassive investments.67

64. The economics of the transaction may be structured to avoid any gift tax by transferring property with a mortgage liability, which reduces the equity in the property to an amount below the gift tax credits and annual exclusions available to the doctor and his wife. Id. §§ 2503, 2513. This avoids the complex valuation of retained interest rules in Section 2701. The trust itself can offset the rent income received on the lease to the settlor-doctor by deducting depreciation on the property, id. §§ 167–168, and the interest on the mortgage. Id. § 163. Because the trust has no significant net income, neither the trust nor the beneficiaries will be subject to tax on the accumulated income at the higher compressed marginal rates of I.R.C. Section 1(e). See supra note 29 and accompanying text.

65. Rosenfeld v. Commissioner, 706 F.2d 1277 (2d Cir. 1983).


67. Other attempts at income splitting with children include the “private annuity.” A taxpayer transfers some income-producing property to children who then promise to support her for life. It is similar to a bargain sale and has income and wealth tax consequences, and involves complex valuation issues as well as detailed annuity present value calculations.

The IRS often has attempted to recharacterize such arrangements as the reservation by the taxpayer of a life interest in a grantor trust, as defined by § 677(a). All income from such trusts remains taxable to the grantor under § 671 on the theory that he has not given up sufficient incidents of ownership over the property placed in trust.
The larger issue, which is the focus of my thesis in this Article, is why not reverse fields and look upon all income splitting with children as a positive rather than a negative goal of the tax system? This is a far more constructive way to deal with a wider group of children’s access to higher education, instead of litigating formalistic distinctions between good and bad gift-leasebacks.

B. Family Limited Partnerships

A limited liability company or a family limited partnership can be effective for income-shifting purposes, but if the parent retains voting and other managerial control, the income may not be taxable to the children, but instead to the parent. In addition, the recent proliferation of family limited partnerships to reduce gift and estate tax liability has not been readily accepted by the IRS, requiring costly litigation in the courts to establish a complex sequence of valuation discounts for wealth transfer tax purposes. For example, two recent U.S. Tax Court opinions accepted the family limited partnership even though there was no business purpose for their formation.68 However, Strangi was partly reversed on appeal to allow the IRS to pursue its claim in the Tax Court that decedent retained a life estate under section 2036 of the Internal Revenue Code, similar to the parental retention of control theory discussed in this Article.69 There remains much uncertainty as to the future resolution of these issues.

The IRS is particularly likely to contest the taxpayer’s characterization of a private annuity arrangement where the value of the property given up substantially exceeds the present value of the annuity received. Graetz & Schenk, supra note 66, at 549. Two cases illustrating these issues are LaFargue v. Commissioner, 689 F.2d 845 (9th Cir. 1982), aff’d, 800 F.2d 936 (9th Cir. 1986), and Estate of Bergen v. Commissioner, 1 T.C. 543 (1943). Loans to children at no or low (below market rate) interest rates are dealt with in section 7872 of the Internal Revenue Code, which imputes interest income to the parent-lender. See also Dickman v. Commissioner, 465 U.S. 330 (1984) (holding an interest-free loan without consideration to be a gift under the gift tax).

68. Estate of Strangi v. Commissioner, 115 T.C. 478 (2000), aff’d in part, rev’d in part, 293 F.3d 279 (5th Cir. 2002); Knight v. Commissioner, 115 T.C. 506 (2000). The courts recognized the limited partnership for gift and estate tax purposes after parents transferred assets to a family partnership, becoming limited partners. The court discounted the value of the limited partnership interests as minority interests and as lacking marketability thus reducing gift and estate tax liability.

69. Estate of Strangi v. Commissioner, 293 F.3d 279 (5th Cir. 2002). Litigation continues in the Strangi context. See, e.g., Estate of Strangi v. Commissioner (Strangi II), 85 T.C.M. (CCH) 1331 (2003) (on remand from the Fifth Circuit); Estate of Stone v. Commissioner, 86 T.C.M. (CCH) 551, 578–81 (2003) (dealing with the bona fide sale exception to section 2036(a) of the Internal Revenue Code; see J. Joseph Korpics, Mining Stone For Material Direction Regarding the Bona Fide Sale Exception (And More) as Applied to FLPs, 102 TAX NOTES 1123 (Mar. 1, 2004).
The attitude of the courts toward family partnerships in general is that they are tax-avoidance devices. For example, in *Strangi* the Tax Court stated: “Family 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.’”70 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.71

V. A FEW PROPOSED SOLUTIONS

The present state of the tax law on income splitting with minor and adult children sanctions 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 $9550 (for 2004) is taxed at the highest marginal rate of 35%72—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.73 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 and other laws on future generations of children.74

The combination of lack of uniformity and incomplete data makes it imperative that we explore alternative ways to deal with these income splitting issues. One plausible solution would be to flatten the income

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70. *Estate of Strangi*, 115 T.C. at 484 (emphasis added).
71. Id. at 492–93.
72. I.R.C. § 1(e).
73. See the illustrative case on Mother’s gift of public stock, *supra* note 22 and accompanying text.
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.\footnote{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.}{75} However, it is probably unrealistic to explore this flat rate alternative at this time in the context of the present income tax structure.

The consumption tax proposals introduced in Congress in the mid-1990’s, such as the “Flat Tax,”\footnote{Freedom and Fairness Restoration Act of 1995, H.R. 2060, 104th Cong. (1995).}{76} would have (1) adopted a single, flat rate structure, (2) taxed all businesses alike (whether income was produced from capital investment or services), and (3) eliminated any need for a ban on “assignment of income.” While the recent rate reductions on dividend and capital gain income\footnote{See supra note 4.}{77} 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.\footnote{For a few examples of the advantages and disadvantages of a consumption-type tax, see William D. Andrews, \textit{A Consumption-Type or Cash Flow Personal Income Tax}, 87 HARY. L. REV. 1113 (1974); Alvin Warren, \textit{Would a Consumption Tax Be Fairer than an Income Tax?}, 89 YALE L.J. 1081 (1980); Lester B. Snyder & Marianne Gallegos, \textit{Redefining The Role of the Federal Income Tax: Taking the Tax Law “Private” Through the Flat Tax and Other Consumption Taxes}, 13 AM. J. TAX POL’Y 1 (1996); Lester B. Snyder & Roger J. Higgins, \textit{Evaluating the Consumption Tax Proposals: Changes in the Taxation of Interspousal Transactions, Use of Trusts, and Revising the Meaning of “Tax Planning”}, 33 SAN DIEGO L. REV. 1485 (1996).}{78}

Another alternative is to do away with artificial tax law distinctions involving “parental control” and abolishing the increasingly difficult distinction between income from services and income from capital. This also might be a politically unrealistic proposal without first ascertaining the stakes involved and getting a handle on what types and amounts of income splitting with children are actually occurring.

To eliminate discrimination I suggest, as a starting point, consideration of a two-pronged short-term (perhaps five years) proposal:

1. Taxpayers with minor children or perhaps grandchildren could elect to shift up to 5% of their current adjusted gross income (whether active or passive, whether from public or private business, including wages or other services income) to their minor children or grandchildren.
through a specially defined (by federal tax law) uniform custodial account.

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 with taxable income over $100,000. The credit could be limited to one child (under seventeen 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. More flexibility could be achieved by allowing an election between parent and grandparent as to which one takes the credit in a particular year.

79. An alternative method could be similar to the current child credit, which provides for an annual credit of $700 (increasing to $1000 in 2010) per child, without the $110,000 of adjusted gross income threshold limitation ($75,000 for single parents). I.R.C. § 24 (2004). 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, 25B), which are nonrefundable credits, can be replaced with the broader based credit I am proposing. See id. §§ 25A, 25B.

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 IRS’s Statistics of Income Bulletin for individual tax returns for the year 2002. Internal Revenue Service, Statistics of Income Bulletin (Washington, D.C. Winter 2003–2004). 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. Id. at 15. The total revenue cost of these two credits, about $26.5 billion, could be replaced with the proposal suggested in this Article 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 credit of 5% of taxable income, the total revenue cost would depend on the number of children (using under seventeen 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, we are 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. Id. A 5% credit on taxable income results in about $50 billion in revenue cost to the government. The distribution effect among income classes (by size of taxable income) would depend on a number of factors, but by 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.
In addition, a significant portion of the nontax 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.\(^{80}\)

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.

VI. CONCLUSION

Our graduated 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 some shares of a parent’s publicly traded securities.

Tax lawyers and tax academics, unfortunately, appear to condemn

\(^{80}\) The proposal suggested in this Article is more equitable than the recent Treasury Department proposal for tax exempt “Lifetime Savings Accounts” (allowing contributions of $7500 a year, with capital gains, dividends, and certain interest earned in the accounts treated as tax-free). Arguably, this is more expensive, more damaging to existing pension/retirement plans, and may jeopardize savings bank accounts. It would also have little benefit for low-income Americans. See Letter from Frank Keating of the American Council of Life Insurers, to Secretary of the Treasury (Jan. 20, 2004) (published in Insurance Group Wary of Lifetime Savings Account Plan, 2004 TAX NOTES TODAY 23–53, Feb. 4, 2004); see also Thomas B. Edsall & Jonathan Weisman, Wall Street Firms Funnel Millions to Bush: Finance Sector Produces Surge of Cash to President Who Cut Taxes on Dividends, Gains, WASH. POST, May 24, 2004, at A04.
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 5% refundable tax credit election by parents 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 children’s 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 that has driven so much of the case law in this area.