Taxing Small and Common Gifts: Tax Law vs. Taxpayer Perception

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I. Introduction

Most taxpayers are aware that if they make substantial gratuitous transfers to their children, parents, or friends, they are subject to an excise tax commonly referred to as the gift tax.[1] Many taxpayers believe that if these transfers are in the nature of support payments or small or customary gifts such as for a birthday present, then those payments do not fall within the definition of a taxable gift.

Confusion over whether common everyday transfers are taxable gifts may have always existed, but it increased in 1984 when the Supreme Court, in *Dickman v. Commissioner*,[2] raised the question of whether there is a gift tax exception for small common everyday transfers.[3] Rather than address the question of whether *Dickman* did create such an exception, most articles focus on its implications on more complex planning such as intrafamily loans,[4] limited liability partnerships,[5] limited partnerships,[6] sales of remainder interests,[7] self-canceling installment notes,[8] private annuities, grantor retained annuity trusts,[9] grantor retained unitrusts,[10] charitable remainder unitrusts,[11] and minority discounts.[12]

This article instead addresses this simple question: Is there a gift tax exception for small customary gifts? It argues that the only exception is the $10,000 annual exclusion that Congress provided as a means of dealing with small transfers and that taxpayers who make transfers in excess of $10,000 and who don't report these as taxable gifts may be engaged in tax avoidance. However, the IRS has shown no interest or ability to deal with this problem.

II. Review of the Estate and Gift Tax — Small Gifts

A. General Review

To understand whether common transfers of small gifts are taxable gifts, a basic understanding of the estate and gift tax law is required.[13] Simply stated, the current estate and gift tax is a single unified transfer tax (an excise tax) for the privilege of giving away one's assets, applicable to both gifts and transfers at death made after December 31, 1976.[14] The current estate and gift tax rates begin at 18 percent and reach a rate of 55 percent on cumulative transfers in excess of $3 million.[15]

A unified credit of $192,800[16] is equal to and therefore offsets the tax on $600,000 of cumulative lifetime and/or testamentary taxable transfers. A taxpayer can therefore make taxable transfers up to $600,000 without incurring a gift or estate tax.[17] This is sometimes referred to as the $600,000 lifetime exemption or exclusion even though it is technically a credit against the tax on the first $600,000 of taxable transfers. Additional lifetime or testamentary transfers are subject to the unified tax.[18]

In the absence of an exclusion for birthday presents and other small gifts, taxpayers would be required to file gift tax returns to track the use of their lifetime exemption. Congress therefore passed an annual exclusion, which currently excludes from the definition of taxable gifts the transfer of up to $10,000 per year per donee "to obviate the necessity of keeping an account of and reporting numerous small gifts."[19] The amount of the exemption was set "sufficiently large to cover in most cases wedding and Christmas gifts and occasional gifts of relatively small amounts."[20] The an-

[1] Section 2501(a)(1) states in pertinent part that "A tax, . . . is hereby imposed . . . on the transfer of property by gift . . . by any individual, resident or nonresident."

[2] 465 U.S. 330 (1984), *aff'g* 690 F.2d 812 (11th Cir. 1982), *rev'g* and *rem'g* T.C. Memo. 1980-575.

[3] *Id.* at 341-342.

[4] *See*, e.g., Marilyn E. Nelson, "The *Dickman* Case: The Service's New Tool," 14 *Tax Mgmt. Inc., Est. Gifts, & Tr. J.* 59, March 9, 1989.

[5] *See* Peter J. Melcher, "Estate Planning Advantages of LLCs Over S Corporations," 73 *Taxes* 151 (1995).

[6] *See* Travis L. Bowen and Rick D. Bailey, "Limited Partnerships: Use in Tax, Estate and Business Planning," 4 *Elder. L. J.* 143 (1996); and Troy Renkemeyer, "Comment: The Family Limited Partnership: An Effective Estate Planning Tool," 64 *UMKC L. Rev.* (1996).

[7] *See* Steven A. Horwitz, "Economic Reality in Estate Planning: The Case for Remainder Interest Sales," 73 *Taxes* 386 (1995).

[8] *See* Esterced, "SCINS Are Still Useful Tools Despite Recent Decision," 21 *Est. Plan.* 12 (1994).

[9] *See* Mitchell M. Gans, "GRITs, GRATs and GRUTs: Planning and Policy," 11 *Va. Tax Rev.* 761 (1992).

[10] *See* "Succession Planning for the Family Business Enterprise: Sales, GRATs and Donative Transfers-the Comparative Advantages," 74 *Taxes* 428, 434-437 (1996). See generally Howard Zaritsky, Tax Planning for Family Wealth Transfers (WG&L).

[11] *See* Jay Soled, "The Versatile Use of Charitable Remainder Unitrusts," 74 *Taxes* 308 (1996).

[12] *See* Carl Radom and Michael Yuhas, "Disputes Over Minority Discounts Continue," 29 *Prac. Acc.* 30 (1996).

[13] *See* John A. Miller and Jeffrey A. Maine, "Fundamentals of Estate Planning," 32 *Idaho L. Rev.* 197 (1996).

[14] Section 2001. Prior to unification of the estate and gift tax, the gift tax was enacted as a separate tax to supplement the estate tax because, in its absence, taxpayers could have avoided the estate tax by transferring their property prior to death. H.R. Rep. No. 708, 72d Cong., 1st Sess. (1932) p. 28; Sen. Rep. No. 665, 72d Cong., 1st Sess. (1932) p. 40. *See also Higgin v. Comm.*, 129 F.2d 237, 240 (1st Cir. 1942).

[15] Section 2001(c).

[16] Section 2505.

[17] The Taxpayer Relief Act of 1997, P.L. 105-34, gradually increases the estate and gift tax exclusion to $1 million in 2006.

[18] Many experts have called for the repeal of the estate and gift tax. *See generally* Bruce Bartlett, "The End of the Estate Tax?" *Tax Notes*, July 7, 1997, p. 105, and the articles cited in footnote 30 therein.

[19] H.R. Rep. No. 708, 72d Cong., 1st Sess. (1932), reprinted in 1939-1 C.B. (Part 2) 457, 478; S. Rep. No. 665, 72 Cong., 1st Sess. (1932), reprinted in 1939-1 C.B. (Part 2) 496, 525-26.

[20] *Id.*

nual exclusion has also been justified as a device for taxpayers to make tax-free gifts of "relatively small value without having to pay a gift tax or file a gift tax return."[21] Congress more recently suggested that the annual exclusion was also intended as an incentive for making lifetime transfers.[22]

Enacted as part of the initial gift tax legislation in 1924, the original annual exclusion was $500 for gifts to each donee each year.[23] This was in addition to an annual exclusion of $50,000 for all gifts made during the year to all donees as a group.[24] The gift tax was repealed in 1926[25] and reinstated in 1932, when the two exclusions were combined into a $5,000-per-year per donee exclusion.[26] Six years later, the House considered a reduction to $3,000 "in view of the frequency with which donors . . . build up estates . . . for the members of their families."[27] However, the Senate partially disagreed; the exclusion was reduced to $4,000 beginning in 1939[28] and further reduced to $3,000 in 1942. It might have been totally eliminated except that "administrative difficulties prevent the abolition of the exclusion."[29] To make up for the effects of inflation, the current "annual exclusion" was raised to its current level of $10,000 in 1981,[30] for transfers made after December 31, 1981.[31]

B. Deductions and Exclusions

An annual gift tax return must be filed for all taxable gifts made each year.[32] The term taxable gifts means the total amount of gifts made during the calendar year, less any statutory exclusions.[33] The amount of the gift tax is also reduced by several deductions. However, in the case of deductible gifts, a gift tax return must be filed.[34]

Deductions are provided for transfers between spouses[35] and for gifts to qualified charities.[36] In addition, contributions to political organizations are not considered gifts.[37] Exclusions are provided for tuition payments made directly to an educational organization,[38] payments made directly to a medical care provider,[39] and for gifts of up to $10,000 per donee per year. The $10,000 amount will be indexed for inflation beginning after 1998.

C. The $10,000 Annual Exclusion

Internal Revenue Code section 2503(b) provides:

> In the case of gifts (other than of a future interest in property) made to any person by the donor during the calendar year, the first $10,000 of such gifts to such person shall not, . . . be included in the total amount of gifts made during such year.[40]

Taxpayers can use this annual exclusion to make transfers of up to $10,000 per year to numerous donees without incurring a gift tax liability or using up their lifetime exemption. Over the years this can substantially reduce the transferor's taxable estate, resulting in a tax savings of up to 55 percent of the amount transferred.[41] Many wealthy taxpayers utilize the full exclusion by writing $10,000 checks annually to their children, relatives, and friends.

Using annual gifts for estate tax reduction is so well-known and understood that the family of an incompetent requested and received court approval for annual gifts "for reasons of prudent estate planning."[42] Use of the annual exclusion as a method of tax planning is so simple[43] that even a dying taxpayer made gifts equal in amount to the annual exclusion "without the knowledge of his attorney."[44]

D. What is a Taxable Gift?

Once the $10,000 annual exemption level has been reached, many taxpayers make additional transfers of property but fail to recognize that these transfers are taxable gifts. Taxpayer failure to recognize a taxable gift may in part be due to the fact that there is no simple definition of a taxable gift. Rather, the gift tax is imposed on direct or indirect transfers of property, whether the property is real or personal, tangible or intangible,[45] if the transfer is made for less than "adequate and full consideration in money or money's worth."[46] In determining the coverage of the gift tax, the Supreme Court has stated:

[21] John G. Steinkamp, "Common Sense and the Gift Tax Annual Exclusion," 72 *Neb. L. Rev.* 106, 166 (1993).

[22] H.R. Rep. No. 94-1380, 94th Cong., 2nd Sess. (1976), reprinted in 1976-3 C.B. 735, 746.

[23] Revenue Act of 1924, P.L. 68-176, 321(a)(3), 43 Stat. 253, 313-314.

[24] Revenue Act of 1924, P.L. 68-176, 321(a)(1), 43 Stat. 253, 314.

[25] Revenue Act of 1926, P.L. 69-20, 324, 42 Stat. 9, 86.

[26] Revenue Act of 1932, P.L. No. 72-154, 504(b), 47 Stat. 169, 247.

[27] H.R. Rep. No. 1860, 75th Cong., 3rd Sess. (1938), reprinted in 1939-1 C.B. (Part 2) 728, 772.

[28] Revenue Act of 1938, P.L. 75-554, 505(b), 52 Stat. 447, 565.

[29] H.R. Rep. No. 2333, 77th Cong., 1st Sess. (1942), reprinted in 1942-2 C.B. 372, 403.

[30] H.R. Rep. No. 97-201, 97th Cong., 1st Sess. (1981), reprinted in 1981-2 C.B. 352, 393; S.Rep. No. 97-144, 97th Cong., 1st Sess. (1981), reprinted in 1981-2 C.B. 412, 462.

[31] P.L. 97-34, section 441(a).

[32] Section 2501(a).

[33] Section 2503(a).

[34] Thus, if a taxpayer gives $100,000 to charity, a gift tax return must be filed, even though there is no net taxable gift or any gift tax payable. Based on changes made by TRA '97, a gift tax return no longer needs to be filed for most charitable contributions. Section 6019(3).

[35] Section 2523.

[36] Section 2522.

[37] Section 2501(a)(5). There is no comparable exception in the estate tax law for political donations at death.

[38] Section 2503(e)(2)(A).

[39] Section 2503(e)(2)(B).

[40] Section 2503(b). This article will not discuss the present interest requirement, since it presumes a current cash or property transfer, rather than the typical transfer in trust, which may be a future interest which does not qualify for the exclusion. *See* reg. section 25.2503-3.

[41] Transferring property not only reduces the transferor's estate by the value of the property transferred, it also reduces the estate by the property's posttransfer earnings.

[42] *Estate of Himmelstein v. Comm.*, 73, T.C. 868 (1980).

[43] Transfers of cash to adult children and friends is very simple. For minor children, trusts or guardianships may make the process more complicated.

[44] *Estate of William A. Lidbury, v. Comm.* 84 T.C. 146 (1985).

[45] Section 2511(a).

[46] Section 2512(b). This determination is based on the objective rather than subjective facts of the transfer. Reg. section 25.2511-1(g)(1). Thus, a gift is taxable even if there is no donative intent.

The language of these statutes is clear and admits of but one reasonable interpretation: transfers of property by gift, by whatever means affected, are subject to the federal gift tax. . . . The plain language of the statute reflects . . . [that] the gift tax was designed to encompass all transfers of property and property rights having significant value.[47]

The term "significant" is misleading since the Court stated that the gift tax is comprehensive and analogous to section 61, which applies to "all income from whatever source."[48] "Similarly, the gift tax applies to any 'transfer of property by gift.'"[49] Thus, it seems clear that even an insignificant present such as a $50 watch given as a birthday present is a taxable gift.

E. Practice vs. Law

The law as discussed by the Supreme Court is very clear; all gifts are taxable gifts unless there is a statutory exception or deduction. However, taxpayer practice does not conform to the law. According to Professor Boris Bittker, the statutory $10,000 annual exclusion has become thought of as an allowable tax-free transfer that can be made in addition to other presents given during the year. "Thus, despite its origin as a method protecting wedding and Christmas gifts against tax, the exclusion has come to be thought of as an estate planning device for transfers in addition to birthday and Christmas presents."[50] Similarly, most taxpayers treat voluntary support payments of their parents or adult children as transfers that are not taxable gifts.[51]

It is interesting that in the 15 years since Professor Bittker noted the common misunderstanding, the IRS has failed to address the issue whether there is a small gifts exception in addition to the annual exclusion. For example, a regulation uses an example that included a large gift in addition to a gift equal in amount to the annual exclusion, thus avoiding the issue of small gifts. The example under the prior $3,000-per-year annual exclusion states:

Example (1). A made a gift of $3,000 to B on January 8, 1971, and on April 20, 1971, gave B an additional gift of $10,000. A made no other gifts in 1971. The total amount of gifts made by A during the second quarter of 1971 is $10,000 because the $3,000 exclusion provided by section 2503(b) is first applied to the January 8th gift.[52]

The IRS could have resolved the small gifts issue by adding the following example:

Example (2). Same as example (1) except that A's additional gift to B was not $10,000 but rather it was a $50 birthday present. Since the transfer of $50 is (or is not) a taxable gift, a gift tax return should (or should not) be filed.

Taxpayers looking for authority for a small gift exception can point to the Supreme Court's *dicta* in *Dickman*:

Petitioners argue, the Commissioner's rationale would elevate to the status of taxable gifts such commonplace transactions as a loan of the proverbial cup of sugar to a neighbor or a loan of lunch money to a colleague. Petitioners urge that such a result is an untenable intrusion by the Government into cherished zones of privacy, particularly where intra-family transactions are involved. . . . It is not uncommon for parents to provide their adult children with such things as the use of cars or vacation cottages, simply on the basis of family relationship. We assume that the focus of the Internal Revenue Service is not on such traditional familial matter.[53]

Unfortunately, the Court went on to invite taxpayer resistance to proper gift tax reporting by adding: "when the Government levies a gift tax on routine neighborly or familial gifts, there will be time enough to deal with such a case."[54] If the IRS had taken the time to address this issue, it would have pointed out that Congress has already dealt with this issue. It stated that the annual exclusion, currently $10,000, was designed to deal with this problem. It was passed "to obviate the necessity of keeping an account of and reporting numerous small gifts"[55] such as "wedding and Christmas gifts and occasional gifts of relatively small amounts."[56] Thus, the Supreme Court was correct in asserting that there is an exception for a cup of sugar. However, it is a statutory exception, the $10,000 annual exclusion. Any additional gifts including a cup of sugar, are taxable gifts unless they are excludable or deductible as provided by statute.

F. Assuming No Exception

Given Congress's specific statement that birthday and Christmas presents are to be excluded from the definition of taxable gifts only if worth less than the amount of the annual exclusion, it does not appear that there is an additional small gift exception. A taxpayer's failure to report small taxable gifts thus is simply another form of gift tax avoidance, which often results in substantial estate tax savings. For example, suppose that for 10 years a taxpayer gives each of 10 relatives $10,000, plus an additional birthday present of $1,000 each and dies with a $1 million estate. Not treating the $1,000 gifts as taxable gifts results in the avoidance of $41,000 in taxes, computed as follows:

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[47] *Estate of Dickman v. Comm.*, 405 U.S. 330, 334, 104 S.Ct. 1086, 1089 (1984).

[48] *Id.*, footnote 4.

[49] *Id.*

[50] Boris I. Bittker, "The $10,000 Annual Per-Donee Gift Tax Exclusion," 44 *Ohio St. L. J.* 447, 448 (1983).

[51] Harry L. Gutman, "A Comment on The ABA Task Force Report on Transfer Tax Restructuring," 41 *Tax Law.* 653, 660 (1988).

[52] Reg. section 25.2503-2(e), Example (1).

[53] 465 U.S. 330, 341-342 (1984).

[54] *Id.*

[55] H.R. Rep. No. 708, 72d Cong., 1st Sess. (1932), reprinted in 1939-1 C.B. (Part 2) 457, 478; S. Rep. No. 665, 72 Cong., 1st Sess. (1932), reprinted in 1939-1 C.B. (Part 2) 496, 525-26.

[56] *Id.*

	Taxable Gifts Not Reported	Taxable Gifts Reported
Value of Estate	$1,000,000	$1,000,000
Add: Birthday Gifts	0	100,000[57]
Taxable Estate	$1,000,000	$1,100,000[58]
Tax (after credit)	$153,000	$194,000
Difference		$41,000

G. Why the IRS Fails to Audit

Given the potential tax avoidance from the failure to report "small" gifts, it is unclear why the IRS has paid no attention to this issue. Maybe it is because an IRS audit will produce no current tax from taxpayers who have made cumulative gifts of less than lifetime exclusion ($600,000 for 1997). The unreported gifts would simply use up a part of the taxpayer's lifetime exemption. It may also be due in part to the fact that the IRS is aware that even if it stated that gift tax returns are required for small gifts, there still would be extremely high levels of noncompliance because taxpayers perceive that this is an area that the IRS will not and cannot effectively audit.[59] Thus, the IRS has nothing to gain by publicly stating that it intends to enforce an unenforceable law, a lesson it may have learned from its inability to enforce the "Nanny" tax.[60]

III. Gift Tax Avoidance — Larger Gifts

In addition to the small taxable gifts that taxpayers fail to report, many taxpayers gratuitously transfer substantial amounts of cash or other property without reporting the transfers as taxable gifts. Whether these transfers are taxable gifts will depend on the relationship between the parties, the purpose of the transfer, and whether there is a gift tax exemption or exclusion.

A. Gifts to Spouses

1. While Married

There is an unlimited marital deduction for gifts to any person "who at the time of the gift is the donor's spouse."[61] Thus, outright transfers during marriage are not taxable gifts, regardless of the donor's motivation or the amount transferred, and no gift tax return is required to report spousal transfers.[62] An unlimited marital deduction is also provided for indirect transfers to a spouse through a qualified terminable interest trust,[63] joint tenancy,[64] a life estate where the donee spouse has a power of appointment,[65] or a charitable remainder trust.[66] Similar rules provide unlimited tax-free transfers to a spouse at death.[67] If the spouse is not a U.S. citizen, the marital deduction for outright gifts is limited to $100,000 inclusive of the otherwise allowable $10,000-per-year exclusion.[68]

2. Divorce Transfers

Under prior law, property settlements were considered taxable transfers unless they were made for adequate and full consideration in money or money's worth.[69] These distinctions, however, became largely academic in 1982 with the adoption of the unlimited marital deduction, as long as the property settlement occurs prior to the divorce.[70] Even if the property settlement takes place after the divorce, a statutory exception states that it will not be treated as a gift if the transfer is under a written agreement that relates to marriage and property rights or provides reasonable child support of the issue of the marriage during minority, but only if the divorce occurs within the three-year period beginning on the date one year before such agreement is entered.[71] There is no requirement that the agreement be approved by the divorce decree.[72] Thus, if covered by the statute, it is unnecessary to prove that the transfer would otherwise be exempt or excluded from the gift tax, either as a transfer to a spouse or as a transfer for adequate and full consideration.[73]

If the transfer occurs after the divorce and does not meet the statutory requirements, the transfer will be treated under prior law as a tax-free transfer for adequate and full consideration in money or money's worth only if it is in exchange for support rights.[74] Thus, a transfer made in exchange for dower or courtesy rights may still be treated as a taxable gift if it is not made during marriage or according to the exception.[75] Similarly, a postdivorce voluntary increase in support payments made to a nonmodifiable divorce decree may constitute a taxable gift because of the lack of adequate consideration.[76] However, if the support decree can be legally modified, modification does not result in a taxable gift.[77]

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[57] $100,000 is derived by multiplying the annual taxable $1,000 by 10 annual gifts for 10 years (1,000 x 10 x 10 = 100,000).

[58] The estate tax calculation includes both the property owned by the decedent at death, plus all prior taxable gifts. Section 2001(b)(1)(B).

[59] Gutman, note 51 *supra*.

[60] *See* Richard B. Malamud, "Nanny Tax Legislation: Not A Practical Solution," *Tax Notes*, March 4, 1996, p. 1401.

[61] Section 2523. *Cf.* section 7703(a)(1), in which for income tax purposes, marriage is determined at the end of the year, not at the time income is earned or deductible expenses paid.

[62] Section 6019(2).

[63] Section 2523(b).

[64] Section 2523(d).

[65] Section 2523(e).

[66] Section 2523(g).

[67] Section 2056.

[68] Section 2523(i).

[69] Reg. section 25.2512-8, which states that the relinquishment of dower or courtesy rights shall not be considered adequate and full consideration.

[70] Section 2523. *See also* Rev. Rul. 80-82, 1980-1 C.B. 209; Henry J. Lischer, 845 T.M. Gifts, A-31 (BNA 1994); Cindy Lynn Wofford, 515 T.M. Divorce and Separation, A-57 (BNA 1995).

[71] Section 2516. *See* S. Rep. No. 1622, 83rd Cong., 2d Sess. 128 (1954).

[72] *Id.*

[73] Rev. Rul. 79-118, 1979-1 C.B. 315.

[74] LTR 8744021, *87 TNT 214-61*. *See also* Rev. Rul. 77-314, 1977-2 C.B. 349; Rev. Rul. 68-379, 1968-2 C.B. 414; and Michel G. Emmanuel, "Property Settlements: Ante-Nuptial, During Marriage, at Termination," 24 *NYU Inst. on Fed. Tax'n* 281 (1966).

[75] Reg. section 25.2512-8.

[76] Rev. Rul. 79-118, 1979-1 C.B. 315.

[77] *Estate of Louis Fabrikant v. Comm.*, 39 T.C. 714 (1963), *acq.* 1964-1 (Part I) C.B. 4.

3. The Engagement Ring

If an engagement ring is transferred to a loved one as a completed gift prior to marriage, the gift tax marital deduction does not apply since the marriage has not taken place. If the value of the ring exceeds $10,000,[78] and title to the ring has transferred to the donee, the transfer appears to be a taxable gift. In most states, however, the transfer will not be a taxable gift because it is not a completed transfer.[79] For example, California law provides:

> Where either party to a contemplated marriage in this State makes a gift of money or property to the other on the basis or assumption that the marriage will take place, in the event that the donee refuses to enter into the marriage as contemplated or that it is given up by mutual consent, the donor may recover such gift or such part of its value as may, under all of the circumstance of the case, be found by a court or jury to be just.[80]

If the transfer of an engagement ring is a conditional gift, the gift is completed for tax purposes at the time of the marriage and no taxable gift exists because it is protected by the unlimited marital deduction. If the marriage does not occur and state law requires that the ring be returned,[81] the gift was never completed and no gift tax is payable. Finally, to add insult to injury, if under state law the donee may keep the ring if the engagement is called off, the "gift" becomes complete at the time of the break up and the transferor has also made a taxable gift, since the transfer of the ring was not made in exchange for property of equal value in money or money's worth.[82]

B. Transfers to Support Minor Children

There is no explicit statute or regulation stating that child support is adequate and full consideration for gift tax purposes. However, a proposed regulation[83] states, and the IRS has ruled, that transfers of property in discharge of a parent's legal support obligation of a minor child is a transfer for adequate and full consideration in money or money's worth.[84] In addition, transfers under a written divorce agreement that provides a reasonable allowance for child support of issue of the marriage during minority are not considered taxable gifts.[85]

To be considered adequate consideration in money or money's worth, support must be legally required and reasonable in amount.[86] Reasonable support is not limited to the bare necessities. Thus, parental obligation to provide support for minor children may recognize occasions such as birthdays as legal obligations rather than as gifts.[87] It should be noted, however, that when dealing with family transfers, courts will subject the transfers to close scrutiny.[88] The IRS is unlikely to take a hard line on parents who provide usual amenities and opportunities for their minor children that exceed their legal responsibility, since such treatment would "never pass muster as a matter of either policy or politics."[89]

Transfers beyond the reasonable needs of the child that are not legally necessary to discharge the parent's support obligation have been held to be taxable gifts.[90] For example, when parents promised their 16-year-old child that upon graduation from college the child would be paid $10,000, the transfer was deemed a taxable gift since the promise to graduate is not adequate consideration in money or money's worth.[91]

C. Transfers to Support Adult Children and Parents

Parents generally are not legally required to support their adult children.[92] Thus, although well intentioned and possibly justified as a moral obligation, providing their support constitutes a taxable gift[93] unless the payment is excluded by statute as the direct payment of qualified tuition or medical expenses.[94] Even when a state court ordered a parent to provide support and maintenance of two adult daughters, there was a taxable gift because of the lack of adequate consideration.[95] The same result applied to payments made to support a minor's parent even though made by the minor's guardian under a state court order.[96] Similarly, when a parent paid the medical bills, mortgage, and the cost of a son's automobile solely for his

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[78] Rings often cost more than $10,000. For example, Donald Trump gave Marla Maples both a friendship ring worth $15,000 and engagement ring worth $250,000. "The Donald Ducks Out: With His Eye On the Bottom Line of His Prenuptial Deal, Donald Trump Says Goodbye to Marla Maples," *People Magazine*, May 19, 1997, p. 122.

[79] *See* John D. Perovich, "Annotation: Rights In Respect of Engagement and Courtship Presents When Marriage Does Not Ensue," 46 *A.L.R.*3d 578, 604 (1972).

[80] Cal. Civ. Code section 1590 (West 1997).

[81] *Priebe v. Sinclair*, 90 Cal. App. 2d 79, 202 P2d 577 (1949).

[82] Although there are no cases directly dealing with engagement rings, it has been held that payments under a legally enforceable antenuptial agreement were taxable gifts because love and affection, the promise to marry, or relinquishing dower or curtesy rights are not considered an exchange of value. Rev. Rul. 69-347, 1969-1 C.B. 227. *See also* reg. section 25.2512-8.

[83] Prop. reg. section 25.2511-1(f)(1), 22 Fed. Reg. 58 (1957).

[84] LTR 9135032, *91 TNT 184-34*.

[85] Section 2516(2).

[86] Prop. reg. section 25.2511-1(f)(1), 22 *Fed. Reg.* 58 (1957), which was not adopted in the current regulations.

[87] Sue A. Wyskiver, "The Federal Income Tax Consequences of the Legal Obligation of Parents to Support Children," 47 *Ohio St. L. J.* 753, 760 (1986).

[88] LTR 8811055, *88 TNT 64-77*.

[89] Jean T. Adams, "Reconciling Family Law With Tax Policy: Untangling the Tax Treatment of Parental Trusts," 46 *Tax L. Rev.* 107, 124 (1990).

[90] *Rosenthal v. Comm.*, 205 F.2d 505 (2d Cir. 1953); *Wiedemann v. Comm.*, 26 T.C. 565 (1956); Rev. Rul. 54-343, 1954-2 C.B. 318. *See also* David Beck & Sheldon V. Ekman, "Where Does Support End and Taxable Gift Begin?," 23 *NYU Inst. on Fed. Tax'n* 1181 (1965).

[91] Rev. Rul. 79-384, 1979-2 C.B. 344. It is interesting that the ruling does not discuss whether this "incentive" could be considered support, since the promise was made while the child was a minor.

[92] *See* "Annotation, Parent's Obligation to Support Adult Child," 1 *A.L.R.*2d 910, 912-913 (1993); *see also* 59 *Am. Jur.* 2d Parent and Child sections 88, 89 (1987).

[93] *Alice H. Lester v. Comm.*, 1 TCM 758, (1943). *See also* Robert G. Popovich, "Support Your Family But Leave Out Uncle Sam: A Call For Federal Gift Tax Reform," 55 *Md. L. Rev.* 343, 361 (1996).

[94] Section 2503(e)(2).

[95] *Comm. v. Greene*, 119 F.2d 383 (9th Cir. 1941), *rev'g* 41 B.T.A. 515 (1940).

[96] *Stokowski v. Pedrick* (DC N.Y. 1952).

love and affection, the entire transfer constituted a taxable gift.[97]

Subjecting a parent to gift tax for supporting an adult child who attends school may not seem very sound as a national policy, but that appears to be the (unenforced) law. Since the gift tax exclusions are limited to the direct payment of tuition and medical expenses,[98] additional support for room, food, entertainment, clothing, supplies, travel, and transportation that exceeds $10,000 per year constitutes taxable gifts.[99] Given the very high cost of room and board alone, most parents who pay to send their children away to college have made taxable gifts. Is there any doubt that not one of them has reported a taxable gift?[100] Questioning the policy behind this result, one article states: "If the purpose of I.R.C. section 2503(e) is to exclude expenditures for support and address the problem of nonenforcement and noncompliance, restricting the exclusion to tuition and direct medical expenses leaves much to be desired."[101]

D. Unmarried Couples

A major area of potential gift tax problems involves unmarried people who live together if one person provides the other with more than $10,000 of support. Unlike married couples with an unlimited marital deduction, unmarried couples have only the $10,000 annual exclusion to offset otherwise taxable transfers.[102] Thus, if A and B live together and A pays all the bills, A will often have made a taxable gift to B exceeding $10,000. This is the same situation as a parent who supports an adult child. It is equally unlikely in either case that the giver will voluntarily file a gift tax return to report the taxable gift or that the IRS will discover the failure to file a return.

If an unmarried couple not only lives together but enters into a palimony contract, the treatment of the transfer as a taxable gift depends on terms of the contract. If the contract provides that the payment is for services, then it will probably be treated as taxable compensation for income tax purposes and as adequate and full consideration for gift tax purposes. If the payment is gratuitous, then it will probably be considered a gift for both income and gift tax purposes.[103]

E. Hosting a Wedding

Hosting a wedding is a taxable gift since the gift tax applies to both direct payments such as wedding presents and indirect transfers such as the cost of the party.[104] The question is not whether there is a gift, but rather, who is the transferee of the gift for gift tax purposes. One possibility is that the wedding is considered a gift from the host to either the bride or groom (whichever is the host's relative). Alternatively, one could argue that the gift is from the host to both the bride and groom.[105] Under both of these possibilities, the taxable transfer will often exceed $10,000 per donee, even if there are two donors and two donees.[106]

Taxable gift status can be avoided if the transfer is considered a pro rata gift to each guest rather than a gift to the bride and groom. Thus, if a 300-person wedding costs $50,000, the "gift" to each guest would be $166.67, well under the allowable $10,000-per-donee exclusion. This seems like a fair result for guests that are friends, business associates, or relatives of the host. However, amounts spent for other guests, who are friends, business associates, or relatives of the bride or groom should probably be considered gifts to the bride and groom, since a host generally does not invite strangers to a party, unless it is for the benefit of one of the honored guests, here the bride and groom.[107]

F. Other Commonly Overlooked Indirect Gift Transfers

Even those taxpayers who believe that there is an exception for small gifts would have a hard time trying to argue that a birthday present consisting of a Rolex watch is not a taxable gift. Similarly, large indirect transfers, such as taking the extended family on an around-the-world vacation or letting an adult child use a car for a year, involves the indirect transfer of thousands of dollars that should be reported as taxable gifts.[108]

Another commonly overlooked potential taxable gift may involve a person who takes a friend to a basketball game! For example, suppose that a season ticket holder with seats "on the floor" for the Lakers or Knicks at a cost of $1,000 per ticket per game takes his or her best friend or child to more than 10 games. Is there any question that this constitutes an unreported taxable gift?

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[97] Rev. Rul. 54-343, 1954-2 C.B. 318.

[98] Section 2503(e)(2). The payment must be made directly to the school or medical care provider or it will be treated as an additional gift.

[99] $20,000 if the child's support is provided by two parents.

[100] It is interesting that an adult child can be a dependent for income tax purposes if the child is a full-time student and under 24 years of age even if the parent is under no legal obligation to support the child. Section 151(c)(1)(B). It would seem to make sense to allow payments qualifying for the income tax exemption to also be exempt from the gift tax.

[101] Popovich, note 93 *supra*.

[102] *See* generally Joan B. Ellsworth, "Prescribing Tums: An Alternative to the Marital Deduction for Unmarried Cohabitants," 11 *Va. Tax Rev.* 137 (1991).

[103] *See* Adam Chase, "Tax Planning For Same-Sex Couples," 72 *Den. U. L. Rev.* 359 (1995).

[104] Reg. section 25.2511-1(a). This is in addition to any direct gift given to the bride and groom by the parents.

[105] In the most egregious case, the IRS could consider the gift solely to the donor's relative, since the parent would arguably have provided the funds for the wedding no matter who the child marries. Thus, the gift is not a gift to the future spouse.

[106] For example, the bride's parents could each provide up to $10,000 to the bride and the groom, thus avoiding a taxable gift unless the cost of the wedding exceeds $40,000.

[107] Can hotel employees increase their "tips" by turning in the host of a wedding for gift tax evasion in hopes of receiving a 10 percent reward from the IRS? Section 7623 and reg. section 301.7623-1.

[108] It is fortunate for these taxpayers that the gift tax only applies to the transfer of property rather than services or there would be a gift every time grandma or grandpa help out by babysitting. Section 2501(a)(1).

IV. Conclusion and Suggestion

Although the law states that the only general exception to the gift tax is the $10,000 annual exclusion, many taxpayers mistakenly believe that they can make additional transfers without considering them to be taxable gifts. The IRS has done little to try to educate the public or to encourage taxpayer compliance. In fact, it appears that the IRS has avoided the issue, probably because it knows that most taxpayers are unlikely to ever voluntarily report small gifts as taxable gifts, even if they exceed the annual exclusion.

If compliance in this area is a desired result, Congress could require annual gift tax returns from donors who make gifts of over $5,000 in any year to a donee. The IRS could then audit those taxpayers likely to have failed to report additional gifts. This form could simply be added to Form 1040 for gifts between $5,000 and $10,000 as Schedule GIFT as follows:

Form 1040 — Schedule GIFT

Taxpayer's name:____________I.D. # _ _ _-_ _-_ _ _ _

1. Name of donee:____________________
2. Relationship of donor to donee:____________
3. Amount of Gift (See instructions for the definition of the term gift):
   - a. Cash____________
   - b. Property__________
   - Total (a + b)__________
4. In addition to the gifts listed above, did you make any other transfers of property to the donee during the year?

   ___ Yes ___ No

If Congress believes, as much as the public does, that there should be a broader gift tax exclusion for indirect transfers, it should expand the law to exclude from the definition of taxable gifts transfers a) for the benefit of any person in the transferor's household, or for anyone under 21 years old, providing the transfer does not result in the acquisition of property of significant value one year later; b) for the educational, medical, or dental costs of any person; or c) for food, clothing, and maintenance of any person who is in fact dependent on the transferor for support, if the payments are reasonable in amount.[109]

It is interesting that Congress and the IRS have had over a decade to address the issue raised by both Professor Bittker and the Supreme Court as to whether small transfers constitute taxable gifts. So far, they have done nothing. Maybe because no one is complaining.

[109] American Law Inst., Recommendation for Federal Estate and Gift Taxation 19-21 (1969).

ACCOUNTING NEWS

FASB RELAXES DERIVATIVES AND HEDGING DISCLOSURE REQUIREMENTS. The Financial Accounting Standards Board on November 19 decided to relax a number of disclosure requirements in its August 29 revised draft standard for derivatives and hedging activities. The board reduced the number of disclosures, reasoning that the disclosures required by Statement 119 are adequate and that additional disclosures would make the document more complex without adding significantly to its usefulness.

The board retained the requirement that entities would have to indicate the amount of other comprehensive income that will be in earnings in the next 12 months. Entities will not have to disclose separate amounts of gains and losses on nonhedging derivatives.

FASB Chair Ed Jenkins asked the staff to discuss with users the changes made to disclosures, to determine whether enough disclosures remain in the document to be useful to analysts. Jenkins noted that if users indicate that these simplifications took too much out of the document, the board would reconsider disclosures at a later date.

The board reaffirmed that entities may not bifurcate derivative instruments. The board said entities would find it too difficult to demonstrate the effectiveness of the components of risk.

Disclosure Effectiveness

Turning to disclosure effectiveness, the board voted 7 to 0 to support a preballot draft of their proposed statement "Employers' Disclosures About Pensions and Other Postretirement Benefits." FASB staff expects to present the board with a ballot draft by Thanksgiving.

The new rule will become effective for tax years beginning after December 15, with earlier adoption encouraged. The board did not accept comment letter suggestions that the components of accumulated postretirement benefits should be disclosed or that the accumulated benefit obligations for funded plans should be disclosed.

— Harriet Hanlon

SENATE BILL WOULD PREEMPT FASB'S DERIVATIVE PROPOSAL. Proposed legislation, S. 1560, introduced on November 13 by Sen. Lauch Faircloth, R-N.C., would bar depository institutions from using FASB's derivatives standard unless federal banking regulators assure Congress the rules will accurately reflect earnings and will not diminish risk management practices.

The preemptive legislation follows two congressional hearings focusing on FASB's proposal and comes when the standard-setting board is preparing to issue the rules before year's end.

"There is great concern in the banking industry about these new accounting standards," Faircloth said in a press release. "In fact, the depth of the opposition