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Human Capital and Transfer Taxation

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## HUMAN CAPITAL AND TRANSFER TAXATION

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A parent pays a child's college tuition bill or an elderly relative's medical bills. Should these transfers be treated as gifts subject to gift taxation? It turns out that this is an extraordinarily difficult question to answer because of the competing considerations in play.<sup>1</sup> The question is so difficult, in fact, that many tax scholars quarantine these transfers in general discussions about the ideal federal wealth transfer tax base.<sup>2</sup> Others who wander into this quagmire often arrive at surprising answers to this question.<sup>3</sup> Economists debating the issue cannot agree on whether education or healthcare payments made on behalf of another should be considered gratuitous transfers.<sup>4</sup> Competing models of donor motivation, including the altruism and bequest-as-exchange models, suggest diametrically opposed accounts of the proper gift tax treatment of these transfers.<sup>5</sup>

It also turns out that how these transfers should be treated under the gift tax system is an enormously important question given the magnitude of wealth transferred for these purposes.<sup>6</sup> Average annual increases in college tuition and medical expenses have outpaced inflation since the early 1980s.<sup>7</sup>

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\* Assistant Professor of Law, Saint Louis University School of Law. I would like to thank Dennis Calfee, Jim Repetti, Adam Rosenzweig, Joshua Tate, Eric Miller, Kenneth C. Halcom, the faculty at the University of Missouri School of Law, and the participants in the Critical Tax and Law & Society conferences for their helpful feedback and comments.

1. The proper normative treatment of human capital under the income tax system has similarly plagued scholars. See, e.g., David S. Davenport, *Education and Human Capital: Pursuing an Ideal Income Tax and a Sensible Tax Policy*, 42 CASE W. RES. L. REV. 793 (1992); Joseph M. Dodge, *Taxing Human Capital Acquisition Costs – or Why Costs of Higher Education Should Not Be Deducted or Amortized*, 54 OHIO ST. L.J. 927 (1993); Louis Kaplow, *Human Capital Under an Ideal Income Tax*, 80 VA. L. REV. 1477 (1994); Lawrence Zelenak, *The Reification of Metaphor: Income Taxes, Consumption Taxes and Human Capital*, 51 TAX L. REV. 1 (1995).

2. See, e.g., RONALD CHESTER, *INHERITANCE, WEALTH, AND SOCIETY* 77 (1982); Anne L. Alstott, *Equal Opportunity and Inheritance Taxation*, 121 HARV. L. REV. 469, 487 (2007) [hereinafter Alstott, *Equal Opportunity*]; Lily L. Batchelder, *Taxing Privilege More Effectively: Replacing the Estate Tax with an Inheritance Tax* 20 (NYU Law & Econ. Research Paper No. 07-25, 2007), available at <http://ssrn.com/abstract=993314>.

3. See, e.g., Mark L. Ascher, *Curtailing Inherited Wealth*, 89 MICH. L. REV. 69 (1990) (generally arguing for confiscatory federal wealth transfer taxation but completely exempting these transfers from the gift tax base).

4. See discussion *infra* Part IV.

5. See discussion *infra* Part IV.

6. See discussion *infra* Part III.

7. According to a 2008 report by the College Board, “Over the past decade, [p]ublished tuition and fees have risen at an average rate of 2.4% per year after inflation at private four-year

Furthermore, with the scheduled repeal of the estate and generation-skipping transfer taxes under the Economic Growth and Tax Relief Reconciliation Act of 2001,<sup>8</sup> the gift tax is poised to become the new front where battles are fought over the legitimacy and scope of federal wealth transfer taxation.

This article initially frames the issue in two ways: (1) through the lens of a proposal by the American Law Institute to exempt all “transfers for consumption” from gift taxation,<sup>9</sup> and (2) within the context of a debate among economists about whether such expenditures should be included in the definition of “intergenerational transfers” for purposes of determining the total share of such transfers in U.S. accumulated wealth.<sup>10</sup> Finding the first lens unsatisfactory on its own doctrinal terms and the second lens inconclusive, the article shifts the focus of analysis to the normative first principles of equality of opportunity and family autonomy, arguing that such principles should be the ultimate arbiter of this federal wealth transfer tax base question.<sup>11</sup> The main claim of this article is that the current exclusion of education and healthcare transfers from the gift tax base is indefensible under an equal opportunity framework, but that outright repeal of the exclusion is neither desirable (because of the competing value of family autonomy) nor politically possible (because of strong taxpayer opposition to the full gift taxation of these transfers).

In arriving at this claim, the article positions the gift tax base inquiry with regard to education and healthcare transfers within a larger debate among liberal egalitarian political theorists over the seeming incommensurability between the norm of equality of opportunity and the institution of the family.<sup>12</sup>

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colleges over the past decade, compared to 2.9% in the preceding decade and 4.1% from 1978-79 to 1988-89.” COLL. BD., TRENDS IN COLLEGE PRICING 2, 9 figs.4 & 5 (2008), available at <http://professionals.collegeboard.com/profdownload/trends-in-college-pricing-2008.pdf>. The College Board further reports that in the same period, “published tuition and fees have risen at an average rate of 4.2% per year after inflation at public four-year institutions, compared to 4.1% in the preceding decade and 2.4% from 1978-79 to 1988-89.” *Id.* Similarly, “health care spending . . . has risen about 2.7 percent faster than the overall economy for the past half century.” ENGELBERG CTR. FOR HEALTHCARE REFORM AT BROOKINGS, REAL HEALTHCARE REFORM IN 2009: GETTING TO BETTER QUALITY, HIGHER VALUE, AND SUSTAINABLE COVERAGE 2 & fig.1 (2008), available at [http://www.brookings.edu/events/2008/~media/Files/events/2008/1117\\_realhealthcare/1117\\_strategicreview.pdf](http://www.brookings.edu/events/2008/~media/Files/events/2008/1117_realhealthcare/1117_strategicreview.pdf).

8. See Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, § 901, 115 Stat. 38, 150.

9. See discussion *infra* Part II.

10. See discussion *infra* Part IV.

11. See discussion *infra* Part V.

12. See, e.g., JAMES S. FISHKIN, JUSTICE, EQUAL OPPORTUNITY, AND THE FAMILY (1983); THOMAS NAGEL, EQUALITY AND PARTIALITY 109-12 (1991); Anne L. Alstott, *Is the Family at Odds with Equality? The Legal Implications of Equality for Children*, 82 S. CAL. L. REV. 1

Congress's "all-or-nothing" approach to the gift taxation of these transfers suggests that it has implicitly adopted the incommensurability view. Prior to 1981, all education and healthcare transfers were subject to gift taxation.<sup>13</sup> This impinged on the individual's liberty interest in family autonomy and consequently led to wide-scale noncompliance and nonenforcement, thus undermining the legitimacy of the gift tax as a whole.<sup>14</sup> Since 1981, all tuition and medical expense payments have been categorically excluded from gift taxation.<sup>15</sup> This approach fails to adequately respect the demands of the equality of opportunity norm.

Given that the foundational principles of equality of opportunity and family autonomy conflict, this article argues that an "all-or-nothing" legislative approach is inappropriate. Rather, Congress should attempt to balance these competing interests by adopting a "middle-ground" approach to the taxation of education and healthcare transfers. This article proposes an alternative to the current unlimited gift tax exclusion for tuition and medical care payments. Specifically, Congress should convert the existing gift tax exclusion into a tax credit available *after* exhaustion of the donor's general gift tax exemption amounts.<sup>16</sup> This approach generally includes education and healthcare transfers in the gift tax base (furthering equality of opportunity) but prevents such inclusion from ever causing a gift tax to be due and payable (recognizing family autonomy concerns). The effect of using a donor's general gift tax exemptions to shelter education and healthcare (human capital) transfers would be a reduction in the amount of tax-free noneducation, nonhealthcare (material) gifts the donor could make. This approach recognizes that human capital transfers pose as much, if not more, of a threat to fair equality of opportunity as do material transfers. Furthermore, forcing a donor to use his or her general gift tax exemptions to shelter education and healthcare transfers seems appropriate in light of the family-autonomy-furthering role these exemptions play in the federal wealth transfer tax scheme.

Part I of this article provides background on the federal gift tax and the existing gift tax exclusion for education and medical expense transfers. Part II critically analyzes the current exclusion's historical antecedent: an American

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(2008) [hereinafter Alstott, *Family at Odds*]; Anne L. Alstott, *Family Values, Inheritance Law, and Inheritance Taxation* (Harvard Pub. Law Working Paper No. 08-49, 2008) [hereinafter Alstott, *Family Values*] (forthcoming in 63 TAX L. REV. (2010)), available at <http://ssrn.com/abstract=1300440>.

13. See *infra* notes 29-30 and accompanying text.

14. See discussion *infra* Part V.B.

15. See Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 441(b), 95 Stat. 172, 319 (codified as amended at I.R.C. § 2503(e) (2006)).

16. See discussion *infra* Part VI.

Law Institute proposal to exempt all “transfers for consumption” (including education and healthcare transfers) from gift taxation. Part III provides a partial estimate of the magnitude of wealth represented by human capital transfers. Part IV describes a lively debate between two economists that illustrates the difficulty inherent in trying to categorize these transfers for gift tax purposes. Part IV also looks to various models of donor motivation to assist in determining the proper gift tax treatment of education and healthcare transfers. Part V places the inquiry within a larger debate among liberal egalitarian political theorists about the competing values of family autonomy and equality of opportunity. Part VI offers an alternative to the current unlimited exclusion for tuition and medical care payments. Part VII concludes the article.

### *I. Background*

The federal estate tax was enacted in 1916.<sup>17</sup> The first federal gift tax was imposed in 1924, primarily to serve as a backstop to the estate tax.<sup>18</sup> The current federal gift tax was enacted in 1932.<sup>19</sup> Before 1976, the gift and the estate taxes operated independently.<sup>20</sup> The Tax Reform Act of 1976 (TRA) unified the two taxes to ensure that the total transfer tax burden would be approximately the same whether a donor transferred property during his or her lifetime, at his or her death, or some combination of the two.<sup>21</sup> TRA achieved integration by applying a unified transfer-tax rate schedule to cumulative transfers—made during life or at death—after application of a single lifetime

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17. See Revenue Act of 1916, ch. 463, § 201, 39 Stat. 756, 777. The original estate tax was imposed for the purpose of raising revenue. See *id.* at pmbl.

18. See Revenue Act of 1924, ch. 234, §§ 319-324, 43 Stat. 253, 313-16. This version of the gift tax was repealed in 1926. Revenue Act of 1926, ch. 27, § 1200, 44 Stat. 9, 125. The federal gift tax also serves as a backstop to the income tax by preventing those in higher income brackets from transferring income-producing property to those in lower income tax brackets in order to achieve a lower combined income tax liability. RICHARD B. STEPHENS ET AL., FEDERAL ESTATE AND GIFT TAXATION ¶ 9.01 (8th ed. 2002).

19. Revenue Act of 1932, ch. 209, §§ 501-531, 47 Stat. 169, 245-59 (codified as amended at I.R.C. §§ 2501-2524 (2006)).

20. Each tax had its own specific exemption and its own rates. See A. James Casner, *Reporter's Study of Dual Tax System and Unified Tax*, in FEDERAL ESTATE AND GIFT TAXATION: RECOMMENDATIONS OF THE AMERICAN LAW INSTITUTE AND REPORTER'S STUDIES 58, 60-61 (1969) [hereinafter A.L.I. RECOMMENDATIONS]; Louis Eisenstein, *The Rise and Decline of the Estate Tax*, 11 TAX L. REV. 223, 244 (1956). Even prior to 1976, some transfers triggered both a gift and an estate tax, in which case a credit against the estate tax was provided for any gift tax paid. Casner, *supra*, at 75.

21. See Tax Reform Act of 1976, Pub. L. No. 94-455, § 2001, 90 Stat. 1520, 1846-54 (codified as amended in scattered sections of the I.R.C.).

exemption amount, which allowed a certain amount of transfers to pass tax-free.<sup>22</sup> TRA also introduced a generation-skipping transfer tax designed to ensure that all property was subject to federal wealth transfer taxation at least once per generation.<sup>23</sup>

Although the gift and estate taxes have shared the same marginal rate schedule since 1976, the effective tax rate imposed on gifts is lower than that imposed on estates because their respective tax bases are different.<sup>24</sup> Estates are taxed on a tax-inclusive basis, meaning that the tax base includes the amount that will go toward paying the tax.<sup>25</sup> By contrast, gifts are taxed on a tax-exclusive basis, meaning that the marginal rates are applied to the net amount received by the transferee, not including the gift tax paid with respect to such amount.<sup>26</sup> The annual per donee exclusion, codified in § 2503(b) of the Internal Revenue Code (IRC), is another salient feature exclusive to the gift tax that reduces the base subject to the unified transfer-tax rate schedule.<sup>27</sup> This provision allows a donor to exclude from gift taxation the first \$10,000, adjusted for inflation, of transfers made to any individual during the taxable year.<sup>28</sup>

Another base-reducing feature available only for gift tax purposes is the exclusion for certain tuition and medical care payments made on behalf of any donee during the taxable year.<sup>29</sup> This exclusion was enacted as part of the Economic Recovery Tax Act of 1981 (ERTA).<sup>30</sup> ERTA significantly reduced the incidence of the federal wealth transfer taxes by, inter alia, increasing the lifetime estate and gift tax exemption incrementally from \$175,625 to

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22. *See id.* § 2006, 90 Stat. at 1879-90.

23. STEPHENS ET AL., *supra* note 18, ¶ 12.01[1].

24. Countering these effects is the fact that gifts generally get a carry-over income tax basis while bequests get a fair market value basis under current law. *See* I.R.C. §§ 1014, 1015 (2006).

25. REGIS W. CAMPFIELD ET AL., *TAXATION OF ESTATES, GIFTS AND TRUSTS* ¶ 1082 (23d ed. 2006).

26. *Id.*

27. *See* I.R.C. § 2503(b); *see also* Robert B. Smith, *Should We Give Away the Annual Exclusion?*, 1 FLA. TAX REV. 361, 382 (1993) (discussing how the annual exclusion can also be thought of as an exception to the estate tax and, under certain circumstances, an exception to the generation-skipping transfer tax).

28. I.R.C. § 2503(b). The inflation-adjusted annual exclusion amount for 2009 was \$13,000. Rev. Proc. 2008-66, 2008-45 I.R.B. 1107, 1113-14, *available at* <http://www.irs.gov/pub/irs-irbs/irb08-45.pdf>.

29. *See* I.R.C. § 2503(e).

30. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 172 (codified as amended in scattered sections of the I.R.C.). For the tuition and medical care payment exclusion, *see id.* § 441(b), 95 Stat. at 319.

\$600,000;<sup>31</sup> increasing the per donee annual gift tax exclusion from \$3000 to \$10,000;<sup>32</sup> enacting an unlimited estate and gift tax deduction for certain intraspousal transfers;<sup>33</sup> and reducing the unified marginal rates of tax.<sup>34</sup>

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) repealed the estate and generation-skipping transfer taxes for decedents dying and generation-skipping transfers made after December 31, 2009.<sup>35</sup> The gift tax, however, remains in effect to serve as a backstop to the income tax.<sup>36</sup> During the period leading up to repeal, EGTRRA also deunified the estate and gift taxes by freezing the lifetime exemption for gift tax purposes at \$1,000,000, but allowing the estate and generation-skipping-transfer tax exemption amounts to increase from \$1,000,000 in 2002 to a maximum of \$3,500,000 in 2009.<sup>37</sup>

The ERTA education and healthcare exclusion was codified as § 2503(e) of the IRC. Section 2503(e) provides that certain tuition and medical care payments are not treated as transfers of property by gift.<sup>38</sup> Unlike the per

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31. *Id.* § 401, 95 Stat. at 299. Technically, the lifetime exemption is called the “applicable exclusion amount” and takes the form of a credit against tax rather than an exclusion from tax. *See* I.R.C. § 2010(c) (2006); *see also* I.R.C. § 2505 (2006). The credit is referred to as the “unified credit.” *Id.* Prior to ERTA, the unified credit amount was \$47,000, which effectively exempted \$175,625 of cumulative transfers from transfer taxation. STAFF OF J. COMM. ON TAXATION, 97TH CONG., GENERAL EXPLANATION OF THE ECONOMIC RECOVERY TAX ACT OF 1981, at 227 (Comm. Print 1981). ERTA incrementally increased the unified credit amount over a six-year period to \$192,800, which effectively exempted \$600,000 of cumulative transfers. *Id.* at 228. Well-advised married couples can effectively double their unified credit amounts. *See* Smith, *supra* note 27, at 372 n.31 (describing how to accomplish this result).

32. Economic Recovery Tax Act § 441(a), 95 Stat. at 319. The exclusion remained fixed at \$10,000 until 1998, but was indexed for inflation thereafter in \$1000 increments. I.R.C. § 2503(b)(2). Married couples can effectively transfer up to two times the annual exclusion to any donee in any year. *See* Smith, *supra* note 27, at 378 (describing how married couples can accomplish this result).

33. Economic Recovery Tax Act § 403, 95 Stat. at 301 (relevant provisions codified as amended at I.R.C. §§ 2056, 2523).

34. *Id.* § 402, 95 Stat. at 300. *See generally* Harry L. Gutman, *Reforming Federal Wealth Transfer Taxes After ERTA*, 69 VA. L. REV. 1183 (1983) (discussing the legislative history, impact, and structure of ERTA).

35. Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, § 501, 115 Stat. 38, 69 (codified at I.R.C. §§ 2210, 2664 (2006)). All of the provisions under EGTRRA are subject to the Act’s sunset provision and will automatically expire on their own terms on December 31, 2010, unless an intervening Congress extends them or makes them permanent. *Id.* § 901(a), 115 Stat. at 150.

36. STEPHENS ET AL., *supra* note 18, ¶ 9.01.

37. Economic Growth and Tax Relief Reconciliation Act § 521 (a), (b), 115 Stat. at 71-72 (codified as amended at I.R.C. §§ 2010(c), 2505 (2006)).

38. I.R.C. § 2503(e).



donee gift tax annual exclusion, there is no limit on the amount that can be excluded under this provision.<sup>39</sup> However, amounts covered by the exclusion are limited to “tuition paid to an educational organization described in section 170(b)(1)(A)(ii)” and amounts paid “to any person who provides medical care (as defined in section 213(d)) . . . as payment for such medical care.”<sup>40</sup>

The legislative history indicates that Congress intended the tuition and medical expense exclusion to be available in addition to the per donee annual exclusion.<sup>41</sup> This suggests that these two provisions serve independent purposes. Historically, the per donee gift tax annual exclusion rested on notions of administrative convenience.<sup>42</sup> By contrast, in enacting § 2503(e), Congress was “concerned that certain payments of tuition made on behalf of children who have attained their majority, and medical expenses on behalf of elderly relatives [were] technically considered gifts under [then-existing] law.”<sup>43</sup>

The “technical” gift resulted from two factors: the donor (1) gratuitously paid the tuition or medical expenses (2) on behalf of someone to whom he owed no legal obligation of support. The IRC provides that “[w]here property is transferred for less than an adequate and full consideration in money or money’s worth,” the difference between the amount transferred and the consideration received “shall be deemed a gift.”<sup>44</sup> Although ostensibly addressing only the valuation of gifts, this standard was interpreted by the Supreme Court to be the test for determining if a gift occurred.<sup>45</sup> Accordingly, the payment of another individual’s tuition or medical expenses without offsetting consideration in the form of money or money’s worth was considered a gift.<sup>46</sup>

There is a doctrinal exemption available for medical and educational payments made on behalf of someone whom the transferor is legally obligated to support. The doctrine considers the discharge of the legal support obligation resulting from such payments as adequate and full consideration in

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39. *See id.*

40. *Id.* § 2503(e)(2)(A)-(B).

41. *See* H.R. REP. NO. 97-201, at 193 (1981); *see also* Treas. Reg. § 25.2503-6(a) (1984).

42. The legislative history indicates that the annual exclusion was intended to “obviate the necessity of keeping an account of and reporting numerous small gifts . . . [and] to fix the amount sufficiently large to cover in most cases wedding and Christmas gifts and occasional gifts of relatively small amounts.” S. REP. NO. 72-665, at 41 (1932).

43. H.R. REP. NO. 97-201, at 193.

44. I.R.C. § 2512(b).

45. *Comm’r v. Wemyss*, 324 U.S. 303, 306 (1945).

46. Love and affection are not considered consideration in money or money’s worth. Treas. Reg. § 25.2512-8 (as amended in 1992).

money or money's worth.<sup>47</sup> Generally, a taxpayer has a legal duty to support his or her spouse and minor children.<sup>48</sup> Accordingly, payments for the education and healthcare of a spouse or minor child are generally not considered gifts. By contrast, these same transfers made on behalf of an adult child or elderly relative, neither of whom the transferor is legally obligated to support, are gifts.

While this "technical" result was generally accepted, it presented problems at the margins.<sup>49</sup> For one, the existence and extent of support obligations were determined under local law, which "[was] neither uniform nor clear on this matter."<sup>50</sup> Thus, the same support-type transfer made to the same transferee might have different gift tax consequences depending on applicable local law. Even more problematic from an enforcement standpoint was the determination of where support ended and a gift began.<sup>51</sup> For example, was private school tuition for a minor child considered a gift to the extent that it exceeded the level of support required by local law?

What was clear is that at a certain point, an individual's legal obligation to provide support for her children ended.<sup>52</sup> In addition, in most states, there was no legally imposed duty to care for elderly relatives.<sup>53</sup> Accordingly, before enactment of § 2503(e), any support-type transfers to a child of age or an

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47. STEPHENS ET AL., *supra* note 18, ¶ 10.02[5]. Although there is no IRC or Code of Federal Regulations section directly on point, a proposed regulation issued shortly after the enactment of the 1954 version of the IRC, which was never incorporated into the final regulations, expressly provided for this result. *See id.*; *see also* Milton L. Ray, *The Transfer-for-Consumption Problem: Support and the Gift Tax*, 59 OR. L. REV. 425, 437 (1981) (hypothesizing that the omission of the proposed language from the final regulations was "because the rule seemed obvious or because the Treasury was unwilling to face problems involving the scope of the amicable family legal obligation").

48. *See* 5 BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 121.5 (2d ed. 1989).

49. *See* Smith, *supra* note 27, at 396-98.

50. Am. Law Inst., *Recommendations with Respect to Federal Estate and Gift Taxation*, in A.L.I. RECOMMENDATIONS, *supra* note 20, at 5, 19.

51. *See* Smith, *supra* note 27, at 397 (suggesting that certain transfers for support "can surely be so luxurious as to involve a gift element"); *see also* CHARLES T. STEWART, JR., INEQUALITY AND EQUITY 51 (1998) (noting the difficulty in drawing "the line between inter vivos transfers and costs of bringing up children," and suggesting that the line has moved as societal norms about parental financial responsibility have evolved in light of the increasing population of high-school graduates attending college).

52. Ray, *supra* note 47, at 428 (restating the general rule that the duty to support a child "ends upon emancipation of the child, upon the child's achieving legal age, entering military service, or getting married").

53. *But see* CAL. FAM. CODE § 4400 (West 2004); S.D. CODIFIED LAWS § 25-7-27 (2004) (both imposing on adult children a legal obligation to support parents who cannot support themselves).

elderly parent were “technically” gifts, and the only gift tax shelter available was the annual exclusion. To the extent that these transfers exceeded the annual exclusion, the taxpayer was required to file a gift tax return to take advantage of his or her available unified credit or to report and pay any gift tax due.<sup>54</sup>

A gift tax exclusion for medical and educational expenses originally appeared in the ERTA legislative history as part of a proposal by a special task force convened by the House Ways and Means Committee in 1981 to address proposed changes to the transfer taxes.<sup>55</sup> On March 4, 1981, Representative Pickle, one of the members of that task force, introduced a bill “to increase the annual gift tax exclusion and to clarify the gift tax treatment of certain transfers for consumption.”<sup>56</sup> The bill proposed the exclusion of certain consumption-type transfers from gift taxation, including payments of another person’s educational, medical, and dental costs.<sup>57</sup> The broad transfer-for-consumption gift tax exception proposed by Representative Pickle derived from a recommendation made by the American Law Institute (ALI) in 1969.<sup>58</sup> Although Congress enacted only a subpart of the ALI/Pickle proposals, many of the current theories underpinning § 2503(e) derive from those espoused by the ALI. Accordingly, the next section describes the ALI proposal and critiques several of the rationales offered in support thereof.

## II. ALI Proposal

In 1969, the ALI adopted a resolution recommending the adoption of a transfer-for-consumption exception to the gift tax.<sup>59</sup> The resolution provided as follows:

An expenditure should be excluded from transfer taxation as a lifetime transfer . . . if the expenditure is for:

(a) the benefit of any person residing in the transferor’s household, or the benefit of a child of the transferor under 21 years

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54. See I.R.C. § 6019 (2006) (requiring that a gift tax return be filed in any calendar year that a taxpayer makes inter vivos transfers other than, inter alia, transfers covered by subsections (b) and (e) of § 2503).

55. Gutman, *supra* note 34, at 1204-05 (noting that the task force made its proposal without the benefit of hearings or public comment).

56. H.R. 2324, 97th Cong. (1981).

57. *Id.*

58. See Am. Law Inst., *supra* note 50, at 5-6.

59. *Id.* This was part of the ALI’s larger project to review the existing federal estate and gift taxes and to suggest improvements “not only to surmount their purely technical deficiencies but also to enhance the fairness and the wisdom of the policies that they are shaped to serve.” Herbert Wechsler, *Foreword to A.L.I. RECOMMENDATIONS*, *supra* note 20, at vii, vii.

of age, whether or not he resides in the transferor's household, provided that such expenditure does not result in such person or child acquiring property which will retain significant value after the passage of one year from the date of such expenditure; or

(b) current educational, medical or dental costs of any person; or

(c) current costs of food, clothing and maintenance of living accommodations of any person in fact dependent on the transferor, in whole or in part, for support, provided such expenditure is reasonable in amount.<sup>60</sup>

While couched in terms of consumption, this resolution actually represented a proposal to exempt three distinct types of transfers: transfers for consumption, transfers for support, and human capital transfers.

*A. Transfers for Consumption (Donor's Own Consumption)*

Under the ALI proposal, expenditures for the benefit of members of the transferor's household and children of the transferor under the age of twenty-one were excluded from taxation if they did not result in the acquisition of "property which will retain significant value after the passage of one year from the date of such expenditure" (subsection (a) exclusion).<sup>61</sup> Nonsignificant-value property transfers would include transfers that purchase consumption on behalf of another.

Although the ALI was not explicit on this point, others have argued that intrahousehold consumption should be excluded from the transfer tax base because it represents consumption by the donor.<sup>62</sup> The federal transfer taxes do not attach to wealth consumed by the transferor for his or her own benefit during his or her lifetime. Consumption purchased on behalf of another, however, is taxable to the purchaser if the purchase does not discharge any legal obligation of support.<sup>63</sup> Intrahousehold consumption creates problems because it is not always clear who benefits from the consumption.<sup>64</sup> According

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60. Am. Law Inst., *supra* note 50, at 5-6.

61. *Id.*

62. See Gutman, *supra* note 34, at 1243 (noting that transfers described in the ALI proposal could be "characterized as consumption by the transferor," even though such "transfers relieve the transferee of the need to expend his or her own resources for the described purposes"); see also Joseph M. Dodge, *Replacing the Estate Tax with a Reimagined Accessions Tax*, 60 HASTINGS L.J. 997, 1025-26 (2008-2009) [hereinafter Dodge, *Replacing the Estate Tax*] (arguing that payments of support are "not true wealth transfers because (a) the payor controls the spending, and (b) support entails current consumption (as opposed to wealth accumulation) by the recipient").

63. See *supra* notes 47-48 and accompanying text.

64. See Robert G. Popovich, *Support Your Family but Leave Out Uncle Sam: A Call for*

to the distinguished Meade Committee, “[I]n general it is impossible to allocate personal consumption between members of a family.”<sup>65</sup> Indeed, the availability of a dependency exemption and the pooling of a child’s income with that of the parent is an implicit partial adoption by the federal income tax of the Meade Committee’s insight.<sup>66</sup>

While this insight certainly has force when one attempts to allocate income among a family or household unit, its impact in the transfer tax area is less clear. The only intrahousehold transfers for consumption subject to gift taxation are those that exceed the annual exclusion made to persons to whom the transferor owes no legal obligation of support.<sup>67</sup> Presumably, the problem of tracing would be minimized when allocating such large-scale consumption to adult beneficiaries.

Furthermore, the normative foundations of the federal wealth transfer taxes are different from those of the federal income tax. As discussed in more detail below, the federal estate and gift taxes attempt to reduce concentrations of wealth harmful to liberty and equality of opportunity.<sup>68</sup> The federal income tax, on the other hand, is designed to raise revenue in the fairest and most efficient manner possible.<sup>69</sup> Donor-financed large-scale consumption may be as problematic from a social policy perspective as large-scale wealth transfers.<sup>70</sup> An individual’s opportunity set is surely substantially enhanced by the provision of every educational, cultural, and social advantage money can buy. Perhaps the ALI’s real concern was that the systematic costs of intruding into family life necessary to police all consumption-related intrahousehold gifts may be too great to justify the small benefit.<sup>71</sup>

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*Federal Gift Tax Reform*, 55 MD. L. REV. 343, 376-80 (1996).

65. INST. FOR FISCAL STUDIES, THE STRUCTURE AND REFORM OF DIRECT TAXATION: REPORT OF A COMMITTEE CHAIRED BY PROFESSOR J.E. MEADE 347 (1978).

66. See Boris I. Bittker, *Federal Income Taxation and the Family*, 27 STAN. L. REV. 1389, 1397-98 (1975).

67. See *supra* notes 47-48 and accompanying text.

68. See Gutman, *supra* note 34, at 1188-89.

69. C. EUGENE STEUERLE, CONTEMPORARY U.S. TAX POLICY 9-15 (2d ed. 2008). Another purpose of the income tax is to implement social policy. *Id.* at 6.

70. Cf. Edward J. McCaffery, *The Uneasy Case for Wealth Transfer Taxation*, 104 YALE L.J. 283, 294 (1994) (arguing, inter alia, that the estate tax encourages large-scale consumption by the donor and that such consumption is problematic on liberal first principles). *But see* Smith, *supra* note 27, at 401 (suggesting that the gift tax system should protect payments made pursuant to a moral obligation and consumed by the transferee).

71. See *Dickman v. Comm’r*, 465 U.S. 330, 340-42 (1984). The benefit of catching all inter vivos family gifts may be small because of the availability of the gift tax annual exclusion and the gift tax unified credit. Ray, *supra* note 47, at 426-27.

*B. Transfers for Support (Consumption Purchased on Behalf of Another)*

The ALI proposal also excluded from gift taxation reasonable payments for the current costs of food, clothing, and shelter made on behalf of persons dependent on the transferor for support (subsection (c) exclusion).<sup>72</sup> Purchases of food, clothing, and shelter are consumption-type expenses. Nevertheless, the doctrinal rationale hypothesized for the subsection (a) exclusion (donor's own consumption) does not apply here because subsection (c) dependents presumably live in separate households.<sup>73</sup> Rather, the ALI proposal labeled basic consumption items purchased on behalf of another (who was neither the legal object of support of the donor nor the de facto object of support of the donor by reason of sharing the same household) as "support" and excluded payments for those items from gift taxation if the recipient was in fact dependent on the donor.

*C. Human Capital Transfers*

The ALI resolution also excluded any payments for the current educational, medical, and dental expenses of any person (subsection (b) exclusion).<sup>74</sup> As a descriptive matter, the transfers described in the subsection (b) exclusion differ from those described in the subsection (a) and (c) exclusions. First, subsection (b) conveyances were excludable no matter on whose behalf they were paid, as long as the transfers were for one of the statutorily prescribed purposes. Second, they were not limited to an amount that was "reasonable" or of "insignificant" value. In other words, the ALI categorically excluded certain types of consumption (or support, if paid on behalf of someone outside the transferor's household) transfers from the gift tax base.

In addition, one could argue that the transfers described in the subsection (b) exclusion are not consumption at all, or at least only partly consumption. Direct expenditures on education and healthcare, among other things, are characterized by economists as investments in human capital rather than consumption.<sup>75</sup> Theodore Schultz, one of the innovators in the economic study of human capital, remarked, "Much of what we call consumption constitutes investment in human capital."<sup>76</sup> There is no bright-line rule for distinguishing between consumption and investment payments. Expenditures that "affect

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72. Am. Law Inst., *supra* note 50, at 6.

73. This interpretation gives independent meaning to subsection (c) by preventing overlap with subsection (a).

74. Am. Law Inst., *supra* note 50, at 6.

75. See generally GARY S. BECKER, HUMAN CAPITAL 15-16 (3d ed. 1993); Theodore W. Schultz, *Investment in Human Capital*, 51 AM. ECON. REV. 1 (1961).

76. Schultz, *supra* note 75, at 1.

particular human capabilities to do productive work” are considered investments,<sup>77</sup> whereas those expenses that merely “satisfy consumer preferences and in no way enhance [productive] capabilities” are considered consumption.<sup>78</sup> Many expenditures are part-consumption and part-investment.<sup>79</sup> Expenditures on education and healthcare, along with expenditures on most other “relevant activities,” fall into the last class.<sup>80</sup>

#### *D. Rationales*

In supporting its transfer-for-consumption proposal, the ALI indicated that it was attempting to bring uniformity to the law pertaining to the legal obligation of support.<sup>81</sup> Recall that differences in local law affect whether and to what extent a gift occurred if a transfer was made to satisfy an obligation of support owed to the transferee.<sup>82</sup> The ALI correctly observed that local law “[was] neither uniform nor clear on this matter.”<sup>83</sup> This lack of state-law uniformity raised a problem with respect to evenhanded application of the federal gift tax laws because it resulted in unequal gift tax treatment of transferors making identical support-type transfers in different jurisdictions.<sup>84</sup> One purpose of the ALI proposal was to “eliminate the significance of differences in local law as to what constitute[d] a legal obligation to support another.”<sup>85</sup> The ALI proposal accomplished this by excluding covered transfers “without regard to whether they in fact involve[d] a discharge of a legal obligation to support.”<sup>86</sup>

The ALI’s uniformity rationale carries very little weight when viewed in the context of the federal wealth transfer tax system as a whole, which does not treat the variable tax consequences resulting from differences in local law as particularly problematic. Local-law differences are inherent in the federal wealth transfer tax system. According to the Supreme Court, “State law creates legal interests and rights. The federal revenue acts designate what interests or rights, so created, shall be taxed.”<sup>87</sup> Accordingly, characterizations of various property interests may differ depending on applicable state law,

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77. *Id.* at 8.

78. *Id.*

79. *Id.*

80. *Id.*

81. Am. Law Inst., *supra* note 50, at 19-20.

82. *See supra* notes 47-51 and accompanying text.

83. Am. Law Inst., *supra* note 50, at 19.

84. *See id.*

85. *Id.* at 19-20.

86. *Id.* at 19.

87. *Morgan v. Comm’r*, 309 U.S. 78, 80 (1940).

resulting in variable transfer tax consequences.<sup>88</sup> In addition, disparities in transfer tax treatment still exist between common-law property states and community property states.<sup>89</sup>

Furthermore, the ALI proposal not only attempted to harmonize the legal obligation of support doctrine but also to extend it. In particular, it allowed gift tax-free transfers to persons to whom the transferor owed no legal obligation of support under any state's law. This group of transferees included nonminor, nonspouse (1) members of the transferor's household; (2) dependents of the transferor; and (3) individuals whose current educational, medical, or dental expenses were paid by the transferor.<sup>90</sup>

The ALI also indicated that it was responding to a "common misunderstanding about the gift tax consequences of responding to the needs of various persons for help; of responding to personalized charity as distinguished from public charity."<sup>91</sup> This public versus private charity distinction is an important one. Section 2522 of the IRC allows an unlimited gift tax deduction for transfers to certain qualified charitable organizations.<sup>92</sup> A transfer from one individual to another individual for a charitable purpose, however, does not qualify for the deduction.<sup>93</sup> Accordingly, it seems relatively clear that rather than clarifying a "misunderstanding" about the gift tax, the ALI was attempting to introduce into it an entirely new concept that would require justifying tax-free transfers by reference to need on the part of the

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88. For example, whether a power of appointment is subject to an ascertainable standard so that it is exempt from estate taxation under I.R.C. § 2041 depends on state law. STEPHENS ET AL., *supra* note 18, ¶ 4.13[4][a]. Substantive state-law differences can result in inconsistent estate tax results. *Compare, e.g.,* Brantingham v. United States, 631 F.2d 542, 543, 547 (7th Cir. 1980) (holding that under Massachusetts law "maintenance, comfort and happiness" was an ascertainable standard), *with* Whelan v. United States, Civil No. 78-0800-N, 1980 WL 1759, at \*1 (S.D. Cal. Sept. 12, 1980) (holding that under California law "support, care and comfort" was not an ascertainable standard).

89. *Compare, e.g.,* I.R.C. § 1014(b)(6) (2006) (giving a fair market value basis to both halves of community property on the death of the predeceasing spouse), *with* I.R.C. § 1014(b)(9) (giving a fair market value basis only to the one-half interest of jointly held property that is includable in the predeceasing spouse's gross estate in a common-law property state).

90. *See* discussion *supra* Part II.A-C.

91. Am. Law Inst., *supra* note 50, at 19. Presumably, this comment was aimed at the subsection (c) exclusion. The subsection (a) and subsection (b) exclusions were not limited to charitable-type payments, but rather to pure consumption by a household member or child of a donor (subsection (a)), or investment in a donee's human capital (subsection (b)). *See supra* text accompanying note 60.

92. *See* I.R.C. § 2522.

93. *See* STEPHENS ET AL., *supra* note 18, ¶ 11.02. This omission of individual-to-individual transfers from the charitable deduction helps to ensure that the gift tax fulfills its function as a "backstop" to the estate tax. *See* Miranda Perry Fleischer, *Charitable Contributions in an Ideal Estate Tax*, 60 TAX L. REV. 263, 268 n.17 (2007).



donee.<sup>94</sup> Under a transferor-based tax system such as the gift tax, however, the donee's financial situation should be irrelevant to determining the tax consequences for the donor.<sup>95</sup>

The ALI also suggested that its proposal would "exclud[e] typical transfers that are motivated by considerations other than the build-up of wealth in the transferee."<sup>96</sup> It is not clear, however, why the subjective intention of the transferor should matter. Unlike the income tax definition of "gift," the transfer tax definition of "gift" is generally not concerned with the subjective motivations of the donor.<sup>97</sup> The gift tax reaches all "transfer[s] of property by gift," without any examination of why the gift was made.<sup>98</sup>

Another possible interpretation of this statement, one that does not require resort to the subjective motivations of the donor, is that to the extent that a gratuitous transfer is immediately consumed by the transferee, there is no continuing wealth to be concerned about from a social policy perspective.<sup>99</sup> While there may be some merit to this view with regard to subsection (c) transfers for reasonable basic support, it is not clear that there is no social policy concern with regard to unequal, gratuitously acquired large-scale consumption.<sup>100</sup> Moreover, to the extent that payment by the donor relieves the donee of an expense that he or she would otherwise have been obligated to pay, the donee is materially better off because current or future assets are not encumbered by such obligation.<sup>101</sup>

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94. See Alstott, *Family Values*, *supra* note 12, at pt. V, para. 3 (suggesting that the law of inheritance and federal wealth transfer taxation would look very different if "we were to take seriously the ideal of the family as a source of insurance against financial hardship"). More specifically, Alstott posits that "inheritance law might require . . . family members to leave their wealth" to the neediest members, a proposition which most would deem an unacceptable incursion on testamentary freedom. *Id.* at para. 4.

95. In contrast, under a transferee-based wealth transfer tax, such as an inheritance or accessions tax, the economic situation of the donee would inherently be taken into account. There have been some recent proposals to replace our current transferor-based system with a transferee-based tax on wealth transfers. See generally Dodge, *Replacing the Estate Tax*, *supra* note 62; Batchelder, *supra* note 2.

96. Am. Law Inst., *supra* note 50, at 20.

97. A gift for income tax purposes depends on the intent of the donor. *Comm'r v. Duberstein*, 363 U.S. 278, 285-86 (1960). Donative intent is generally irrelevant in determining whether a gift occurred for gift tax purposes, although lack of donative intent is relevant in determining whether the ordinary course of business gift tax exception applies. Treas. Reg. §§ 25.2511-1(g)(1) (as amended in 1997), 25.2512-8 (as amended in 1992).

98. See I.R.C. § 2501(a)(1) (2006).

99. See Popovich, *supra* note 64, at 377 & n.161 (arguing that the ALI proposal to exclude transfers for consumption does not violate the social policy against large wealth accumulations because such transfers do not result in "sustained wealth" accumulation in the donee).

100. See *supra* note 70 and accompanying text.

101. Cf. *United States v. Kirby Lumber Co.*, 284 U.S. 1, 3 (1931) (adopting a freeing of

Furthermore, the significance of the human capital characterization for subsection (b) transfers is that it negates the claim that there is no buildup of wealth in the transferee under the ALI proposal. When material transfers purchase education and healthcare for the donee, the donee's earning capacity and, thus, human capital are potentially increased.<sup>102</sup> In other words, in subsection (b) transfers, material wealth is transformed, in part at least, into human wealth rather than completely consumed. The return on human capital, especially when the investment occurs early in the donee's lifetime, may be far greater than the return on an initially equivalent transfer of material wealth.<sup>103</sup> This suggests that from a social policy perspective there may be reason to be more concerned about human capital transfers than material transfers.

Finally, the ALI cited the fact that "[i]t [was] not generally understood by the average person that a gift tax [might] be payable if he provide[d] a child with educational benefits beyond those he [was] legally obligated to provide, or if he pa[id] a sick relative's doctor's bill."<sup>104</sup> This lack of public understanding had led to widespread noncompliance with the law and a general lack of enforcement on the part of the Internal Revenue Service (IRS).<sup>105</sup>

In summary, the following considerations informed the ALI when it adopted its resolution recommending a transfer-for-consumption exception to the gift tax: First, uniformity in application of the federal wealth transfer tax laws is a desirable goal. Second, gratuitously transferred consumption should be excluded from the transfer tax base, especially (1) when it flows from affinity in living quarters or the donor's desire to satisfy the donee's basic needs, or (2) when it takes the form of education, medical, or dental care. Finally, a lack of recognition of these issues on the part of the federal wealth transfer tax system had led to noncompliance and nonenforcement.

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assets theory under the income tax for purposes of finding cancellation of indebtedness income).

102. Obviously, the amount invested will not accurately measure the value of what the donee receives. The actual increase in human capital will depend on the individual donee's ability and effort. The potential mismatch between the amount invested and the resulting increase in human capital led Theodore Schultz to claim that human capital is best measured by its yield (increase in earnings) rather than its cost. Schultz, *supra* note 75, at 8.

103. Cf. BECKER, *supra* note 75, at 274 (noting that "gifts of assets to children do not rise rapidly until marginal rates of return on investments in children [i.e., in human capital] are reduced to the rate on assets").

104. Am. Law Inst., *supra* note 50, at 19.

105. See Ray, *supra* note 47, at 425-27.

*E. Congressional Response*

Under ERTA, Congress declined to implement all of these considerations in the form of the broad transfer-for-consumption exclusion proposed by the ALI. Instead, Congress explicitly enacted only the narrow subsection (b) exclusion for tuition and medical expense payments.<sup>106</sup> Arguably, however, Congress also implicitly adopted the transfer-for-consumption and transfer-for-support portions of the ALI proposal in the form of an increased annual exclusion.<sup>107</sup> Most of the witnesses testifying before the Senate Finance Committee in the hearings leading up to the passage of ERTA advocated an increased annual exclusion as the remedy for the issues identified by the ALI.<sup>108</sup> Enactment in the form of an increased annual exclusion avoided many of the borderline issues inherent in the ALI proposal, including questions regarding what property “will retain significant value” after a year under subsection (a), as well as what constitutes “reasonable” basic support and who is “in fact dependent on the transferor” under subsection (c).<sup>109</sup> Furthermore,

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106. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34 § 441(b), 95 Stat. 172, 319 (codified as amended at I.R.C. § 2503(e) (2006)).

107. Officially, Congress increased the annual exclusions “[i]n view of the substantial increases in price levels since [1942].” STAFF OF J. COMM. ON TAXATION, 97TH CONG., GENERAL EXPLANATION OF THE ECONOMIC RECOVERY TAX ACT OF 1981, at 273 (Comm. Print 1981). This does not contradict the argument in the text because Congress was not specific about what price levels increased. *See id.*; *see also* Gutman, *supra* note 34, at 1246 (suggesting that the dollar amount of the per donee gift tax exclusion would be “affected by how support-type payments, other than those for tuition and medical expenses, are treated”); Smith, *supra* note 27, at 401 (stating that “[t]he desire to permit support-type transfers to be made without fear of gift tax consequences . . . pressured Congress to make the annual exclusion large enough to obviate such fears”).

108. *See, e.g., Major Estate and Gift Tax Issues: Hearing on S. 23, S. 395, S. 404, S. 557, S. 574, S. 588 and S. 995 Before the Subcomm. on Estate and Gift Taxation of the Comm. on Finance, 97th Cong. 184 (1981) [hereinafter Hearing]* (statement of John A. Wallace, American College of Probate Counsel) (“The College also supports a substantially increased per donee annual gift tax exclusion, but does not support an expansion of the exclusion by exempting transfers of property for current consumption.”); *id.* at 316, 319 (statement of Robert M. Bellatti, Chairman, Illinois State Bar Association) (“The \$3,000 amount now does not allow a parent to give a child an American made car or even to pay for a year of college tuition at many schools . . . .”); *id.* at 343, 359-60 (statement of Malcolm A. Moore, Att’y, Davis, Wright, Todd, Riese & Jones) (“I believe that the gift tax annual exclusion should be substantially increased. . . . [I]n most cases an automobile cannot be given to a young adult by his parents without exceeding the present exclusion limits.”). *But see id.* at 156, 175-76 (joint statement of Harvie Branscomb, Jr. and John S. Nolan, Chairman and Chairman-Elect, Section of Taxation, American Bar Association) (arguing for an increase in the annual exclusion, but also arguing for a separate transfer-for-consumption exception).

109. Am. Law Inst., *supra* note 50, at 6; *see also id.* at 20 (acknowledging that the proposed

Congress's solution avoided many of the doctrinal and policy-related questions raised above.

In addition to raising the general level of the gift tax annual exclusion, Congress also enacted the subsection (b) exclusion of the ALI proposal, albeit in a more limited form. The ALI called for *any* educational, medical, or dental expense to be excludable.<sup>110</sup> Section 2503(e) excludes only tuition payments, not all educational payments.<sup>111</sup> The ALI would have excluded *any* medical and dental expense payments, whereas § 2503(e) excludes only those expenses that would qualify for the income tax deduction under § 213.<sup>112</sup> Furthermore, the ALI maintained that if a transfer was made for one of the statutorily described purposes, it should be “immaterial whether payment [was] made on behalf of the transferee or to the transferee for the designated purposes.”<sup>113</sup> By contrast, § 2503(e) excludes covered expenses only if they are paid directly to a qualified educational organization or medical care provider.<sup>114</sup>

Although Congress did not explain why it chose a new exception in addition to an annual exclusion increase rather than just the latter,<sup>115</sup> one can construct a rationale. Tuition and healthcare are costly and irregular expenses, making them particularly unsuitable candidates for annual exclusion coverage.

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“exception [would] raise some difficult factual issues in borderline situations”). See Ray, *supra* note 47, at 446-50, for further elaboration and a suggested solution to some of the inherent indeterminacy in the ALI proposal.

110. Am. Law Inst., *supra* note 50, at 6.

111. I.R.C. § 2503(e).

112. *Id.*; see also I.R.C. § 213. Section 213 encompasses qualifying dental expenses. Treas. Reg. § 1.213-1(e)(ii) (as amended in 1979).

113. Am. Law Inst., *supra* note 50, at 20.

114. STAFF OF J. COMM. ON TAXATION, 97TH CONG., GENERAL EXPLANATION OF THE ECONOMIC RECOVERY TAX ACT OF 1981, at 274 (Comm. Print 1981); Treas. Reg. § 25.2503-6(b)(2),(c) (1984). Although the legislative history does not explain the purpose of the direct payment requirement, presumably it was to avoid having to trace cash from the donor to the donee to the qualified educational institution or healthcare provider. BITTKER & LOKKEN, *supra* note 48, ¶ 121.5; accord Gutman, *supra* note 34, at 1243 n.173. Another possible explanation for this restriction is that it keeps control over the payment in the hands of the donor. A beneficiary who receives \$10,000 in cash has a full range of options available. Such a beneficiary can consume, invest, save, or give the money away. If the beneficiary chooses to use the money on education or healthcare, such beneficiary incurs an opportunity cost by not choosing other uses of the funds. By contrast, a beneficiary of a § 2503(e) transfer has no such choice and bears no such opportunity cost. This seems to suggest that because control over payment of the expense is in the hands of the donor, it is really the donor's consumption and not the donee's; thus, the payment should be excludable. See *supra* note 62 and accompanying text.

115. Smith, *supra* note 27, at 385 (highlighting that Congress did not explain why it chose to simultaneously increase the annual exclusion and create a new medical and tuition exclusion).

Increasing the general level of the annual exclusion to capture these transfers would set the exclusion at too high of a level and allow large amounts of noneducation, nonhealthcare wealth transfers to escape taxation.<sup>116</sup> Furthermore, even if Congress had raised the level of the annual exclusion in 1981 to capture most of these transfers, general inflation adjustments thereafter would not have kept up with the annual increases in these costs. Average annual increases in college tuition and medical expenses have outpaced inflation since the early 1980s.<sup>117</sup>

While it is easy to rationalize the form of the education and healthcare exclusion, it is more difficult to articulate its normative justification. It should be noted at the outset that § 2503(e) achieved some of the uniformity called for by the ALI. Since passage of ERTA, no matter whom a state has required a donor to support and no matter what level of support such state has required, a tuition or medical expense payment has remained gift tax-free.<sup>118</sup> As explained above, however, the uniformity justification is of minimal significance in the current system of federal wealth transfer taxation.<sup>119</sup>

Before this article explores the competing normative considerations in play with regard to human capital transfers, the next two sections seek to provide a rough estimate of the magnitude of the excluded transfers and to illustrate the difficulty in categorizing these payments for transfer tax purposes.

### III. Magnitude

The magnitude of human capital transfers is significant. We can indirectly derive an estimate by analyzing two studies that attempt to estimate the total share of U.S. accumulated wealth attributable to intergenerational transfers as opposed to savings from earned income (so-called life-cycle savings).<sup>120</sup> Laurence Kotlikoff estimates that approximately 80% of all wealth accumulation is due to gratuitous transfers.<sup>121</sup> By contrast, Franco Modigliani

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116. *But cf. id.* at 391-400 (emphasizing that a significant amount of nonconsumption wealth is inappropriately transferred under the current level of the annual exclusion).

117. *See supra* note 7.

118. *See* I.R.C. § 2503(e) (2006) (excluding from taxable gifts amounts paid for tuition and healthcare expenses on behalf of any person).

119. *See supra* notes 87-89 and accompanying text.

120. This is an important issue in and of itself, since the federal wealth transfer taxes are designed to prevent undue accumulations of wealth. If intergenerational transfers constitute an insignificant part of accumulated wealth, this brings into question this policy-based justification for the transfer taxes. *See* Franco Modigliani, *The Role of Intergenerational Transfers and Life Cycle Savings in the Accumulation of Wealth*, J. ECON. PERSP., Spring 1988, at 15, 17 (making a similar point).

121. *See* Laurence J. Kotlikoff, *Intergenerational Transfers and Savings*, J. ECON. PERSP., Spring 1988, at 41, 43. Kotlikoff's figure derives from two earlier studies conducted with

estimates that only about 20% of accumulated wealth is attributable to intergenerational transfers.<sup>122</sup>

Part of the large discrepancy between the two figures results from differing definitions of “intergenerational transfers.”<sup>123</sup> In particular, the two studies diverge on whether the value of lifetime transfers (as opposed to transfers at death), including college tuition payments, should be included.<sup>124</sup> Modigliani includes only bequests at death and major lifetime gifts in his definition of “intergenerational transfers,” excluding all minor lifetime gifts and college tuition payments.<sup>125</sup> In contrast, Kotlikoff treats all gratuitous transfers received by children over the age of eighteen, including college tuition payments, as intergenerational transfers.<sup>126</sup>

The amount of the difference between the two estimates attributable to the inclusion of college expenditures is about 7.8% of aggregate net wealth.<sup>127</sup> A later study by Gale and Scholz concludes that payments for college expenses represent approximately 12% of aggregate U.S. net wealth.<sup>128</sup> Both of these

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Lawrence Summers, and is alternatively referred to as the “Kotlikoff & Summers” estimate. See Laurence J. Kotlikoff & Lawrence H. Summers, *The Role of Intergenerational Transfers in Aggregate Capital Accumulation*, 89 J. POL. ECON. 706 (1981); Laurence J. Kotlikoff & Lawrence H. Summers, *The Contribution of Intergenerational Transfers to Total Wealth: A Reply* (Nat'l Bureau of Econ. Research, Working Paper No. W1827, 1988), available at <http://ssrn.com/abstract=227165>. Kotlikoff arrives at his figure indirectly by estimating savings from earned income (nearly 22%) and then subtracting that estimate from an estimate representing 100% of total wealth, yielding an estimate of inherited wealth (i.e., wealth attributable to intergenerational transfers) that approaches 80%. Kotlikoff, *supra*, at 41-44. Kotlikoff uses a different method to arrive at a “lower bound estimate” of 46% as the share of accumulated wealth represented by intergenerational transfers. See *id.* at 45-46. This second method measures the annual flow of bequests and then uses an appropriate “blow up” factor to infer the stock of inherited wealth. See *id.* at 44-46. Kotlikoff acknowledges several problems with using this second method to arrive at the desired estimate, including the tendency of the “flow” approach to overestimate life-cycle savings because of an absence of data on a variety of transfer flows. See *id.* at 45-46.

122. Modigliani, *supra* note 120, at 28 tbl.2B, 30 (adjusting the Kotlikoff estimates in light of alternative definitions of “life-cycle wealth” and “inherited wealth,” and calling 20% a “consensus figure” among various studies cited in the article).

123. See Kotlikoff, *supra* note 121, at 47; see also Denis Kessler & André Masson, *Bequest and Wealth Accumulation: Are Some Pieces of the Puzzle Missing?*, J. ECON. PERSP., Summer 1989, at 141, 142.

124. See Kessler & Masson, *supra* note 123, at 142.

125. Kotlikoff, *supra* note 121, at 47.

126. *Id.* at 47-48 (assuming that support of children under age eighteen is consumption by the parent and thus not includable as an intergenerational transfer, but noting that the choice of age eighteen as the age of majority for purposes of defining “intergenerational transfers” is arbitrary).

127. Modigliani, *supra* note 120, at 30.

128. William G. Gale & John Karl Scholz, *Intergenerational Transfers and the*

figures almost certainly underestimate the amount of wealth represented by § 2503(e) transfers because they are dated and do not include the value of medical expenses gratuitously paid on another's behalf.

While these estimates illustrate that the total percentage of gratuitous transfers represented by investments in human capital is large, they fail to break down that percentage by income or wealth class. In a seminal 1988 article, John Langbein argues that inter vivos investment in human capital is the dominant form of wealth transfer among the broad middle classes.<sup>129</sup> He also recognizes that the impact of human wealth transfers on “dynastic wealth holders” is probably not as significant.<sup>130</sup> If education and healthcare payments represent a de minimis portion of all inter vivos wealth transfers for those otherwise subject to federal wealth transfer taxation (i.e., the ultrawealthy), then § 2503(e) can be justified in terms of administrative convenience.

#### *IV. Definitional Issues and Donor Motivation Models*

The lively debate between Kotlikoff and Modigliani over the propriety of including college tuition expenditures in the definition of “intergenerational transfers” highlights the difficulty inherent in categorizing these payments for transfer tax purposes. Kotlikoff includes college tuition payments in his definition, reasoning as follows:

[G]iven the fungibility of money there is no reasonable basis for labeling parental tuition support differently from parental gifts of durables, such as cars, or parental gifts of money; that is, whether

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*Accumulation of Wealth*, J. ECON. PERSP., Autumn 1994, at 145, 152 tbl.4 (generating calculations using ROBERT B. AVERY & ARTHUR B. KENNICKELL, ECON. BEHAVIOR PROGRAM, UNIV. OF MICH. SURVEY RESEARCH CTR., SURVEY OF CONSUMER FINANCES, 1986 (1986)). Gale and Scholz separate out college expenditures from other transfers because of the “controversy concerning whether they are appropriately regarded as a transfer.” *Id.* at 151 (citing the opposing positions of Modigliani and Kotlikoff on this issue).

129. John H. Langbein, *The Twentieth-Century Revolution in Family Wealth Transmission*, 86 MICH. L. REV. 722, 723, 729-36 (1988).

130. *Id.* at 736. Langbein's findings may offer an alternative explanation for § 2503(e). One of the driving forces behind the ERTA changes to the federal wealth transfer taxes was Congress's desire to remove the broad middle classes from their impact. Gutman, *supra* note 34, at 1209-12 (questioning Congress's sincerity with regard to achieving this goal). ERTA accomplished this in a number of ways, including increasing the annual exclusion and the unified credit. *See supra* notes 31-34 and accompanying text. Section 2503(e) could be included on this list as well. If human capital transfers make up the largest portion of wealth transfers for the middle class, but only an insignificant portion of transfers for the ultrawealthy, the consequence of exempting such transfers would be removal of upper-middle income taxpayers from the reach of the federal wealth transfer taxes.

the parent pays tuition or gives the child the money to pay tuition is economically equivalent. In addition, there is no reason, as Modigliani suggests, to classify somehow educational expenditures as a human as opposed to nonhuman wealth transfer. The transfer of funds to pay for education constitutes a transfer of nonhuman capital. The fact that the expenditure leads to smarter or more skilled children, as opposed, for example, to fatter children, is quite immaterial to the issue of tracing the origins of nonhuman wealth accumulation.<sup>131</sup>

Kotlikoff clearly views the transaction from the perspective of the donor, which aligns well with the approach of the transferor-based gift tax. Under his view, there is no difference between giving a beneficiary \$10,000 in cash or other property or paying \$10,000 to a university as tuition for the beneficiary. In either case, the donor's estate is reduced by \$10,000 with no consideration received in money or money's worth. Kotlikoff's view represents the straightforward case for inclusion of education and healthcare transfers in the gift tax base.

Kotlikoff critiques Modigliani's approach as effectively "treat[ing] any adult, regardless of age, who received non-bequest transfers from his or her parents, as a 'dependent' and ascrib[ing] the consumption resulting from such transfers to the parent(s)."<sup>132</sup> Interestingly, by including all transfers made to children above the age of majority in the definition of "intergenerational transfers," Kotlikoff implicitly adopts the pre-ERTA transfer tax base.<sup>133</sup> Modigliani, on the other hand, implicitly adopts the ALI's proposed transfer tax base by excluding all consumption-type and college expenditures.<sup>134</sup> Furthermore, Modigliani articulates many of the ALI rationales in defending his position. In particular, he asserts that the excluded transfers "go to pay for current consumption and do not represent an addition to the assets of the recipient or society."<sup>135</sup> He criticizes Kotlikoff for making his estimate crucially dependent on the age of majority,<sup>136</sup> a sentiment echoing the ALI's uniformity rationale.<sup>137</sup> Finally, Modigliani asserts that these types of "imputed transfers are quite different in nature from bequests and major gifts because, unlike [those] transfers, they would be hard to modify through policy

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131. Kotlikoff, *supra* note 121, at 47-48.

132. *Id.* at 47.

133. *See supra* notes 29-30 and accompanying text.

134. *See supra* note 125 and accompanying text; *see also* discussion *supra* Part II.A-C.

135. Modigliani, *supra* note 120, at 31 (articulating a transfer-for-consumption rationale virtually identical to that advanced by the ALI).

136. *Id.*

137. *See supra* text accompanying notes 81-86.



actions.”<sup>138</sup> This statement clearly aligns with the different motives behind these transfers alluded to in the comments to the ALI proposal.<sup>139</sup>

With respect to college tuition payments, Modigliani recognizes that such expenditures could be counted as gratuitous transfers, “since they take the form of an investment in human capital.”<sup>140</sup> He concludes, however, that this characterization does not require one treatment or another. Specifically, he asserts that

this consideration would be relevant mainly for other issues, such as the hereditary transmission of economic inequality or the contribution of transfers to total capital—nonhuman and human. Furthermore, . . . many other expenditures on human capital [should be included], not necessarily only on behalf of dependents 18 years old and over—like all private schooling. And why should the line be drawn at schooling and not include all expenditure on children?<sup>141</sup>

This quote illustrates the competing considerations in play when categorizing these transfers for gift tax purposes. On one hand, if we follow Kotlikoff and reject as unhelpful the artificial label of “consumption by the donor,” we must be willing to take that argument to its logical extreme. Consequently, the doctrine of legal obligation of support would no longer grant automatic immunity from gift taxation for many transfers for the benefit of a minor.<sup>142</sup> This approach would cast a broad net, and the resulting intrusions into family life necessary to enforce such a rule may be too great to justify the small benefit.<sup>143</sup> On the other hand, if we follow Modigliani and ignore all intrafamily human capital transfers, we cast the net too narrowly and miss a large and important source of hereditarily transmitted economic inequality.<sup>144</sup>

The characterization of college tuition payments as intergenerational wealth transfers depends in large part on whether such payments are considered substitutes for material bequests.<sup>145</sup> Modigliani treats property bequests as

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138. Modigliani, *supra* note 120, at 31.

139. *See supra* note 96 and accompanying text.

140. Modigliani, *supra* note 120, at 31 (internal quotation marks omitted).

141. *Id.*

142. *See supra* notes 47-48 and accompanying text.

143. *See generally* Gutman, *supra* note 34, at 1242 (noting that to the extent that § 2503(e) covers education and healthcare payments to minor children, it “merely codifies existing law,” but to the extent that it covers such payments to others, it may be too broad because it reaches beyond the class of persons society could reasonably expect the donor to support).

144. *See* discussion *infra* Part V.

145. *See* Kessler & Masson, *supra* note 123, at 143. In commenting on the Kotlikoff-

differing in kind from inter vivos human capital transfers.<sup>146</sup> Kotlikoff, on the other hand, assumes substitutability between material transfers and payments for an adult child's college education.<sup>147</sup> The implications of the substitutability assumption from a gift tax perspective relate back to the function of the gift tax as a backstop to the estate tax.<sup>148</sup> Under one interpretation of this function, the gift tax need only be concerned about inter vivos transfers motivated by a desire to reduce estate taxation.<sup>149</sup> Thus, only gifts that are perfect substitutes for bequests should be included in the tax base.<sup>150</sup>

As recognized by Kessler and Masson, substitutability depends on two factors: (1) the motivation of the donor in making the transfer and (2) the donee's position after the transfer.<sup>151</sup> While there is much debate in economic circles over donors' motives in making gifts, two dominant models have emerged, namely, altruism and exchange. The altruism model surfaced during the 1970s and 1980s.<sup>152</sup> Under this model, a donor derives utility from the donee's increased utility resulting from the transfer.<sup>153</sup> Accordingly, the donor's utility function includes a term for the recipient's welfare.<sup>154</sup> The idea is that we make transfers to family members "on purpose, because it makes us happy to make them happy."<sup>155</sup> This implies that parents will make

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Modigliani debate regarding the proper treatment of college expenditures, Kessler and Masson ask the following question: "Is it reasonable to assume separability between material bequests and expenditures made on behalf of children?" *Id.*

146. *See id.* Specifically, Kessler and Masson note that under Modigliani's life-cycle hypothesis "the bequest motive is considered in isolation and the process of asset accumulation can be considered relatively apart from labor supply or family-related decisions." *Id.*

147. *See id.*

148. *See supra* note 18.

149. Popovich, *supra* note 64, at 378 (explaining that "[w]hen wealth is merely consumed and not transferred, the gift tax's role as a backstop to the estate tax is not implicated").

150. Notice that this aligns nicely with the ALI rationale regarding the difference in motivations for consumption-type transfers. *See supra* text accompanying note 79.

151. *See* Kessler & Masson, *supra* note 123, at 143 (noting that complete substitutability "supposes also, on the recipient side, that college education has the same impact on later accumulation as a cash transfer").

152. Luc Arrondel et al., *Bequest and Inheritance: Empirical Issues and France-U.S. Comparison*, in *IS INHERITANCE LEGITIMATE?* 89, 119-20 (Guido Erreygers & Toon Vandeveld eds., 1997).

153. *See* Barbara H. Fried, *Who Gets Utility from Bequests? The Distributive and Welfare Implications for a Consumption Tax*, 51 *STAN. L. REV.* 641, 647-50 (1999).

154. *See* André Masson & Pierre Pestieau, *Bequest Motives and Models of Inheritance: A Survey of the Literature*, in *IS INHERITANCE LEGITIMATE?*, *supra* note 152, at 54, 63-64 (providing a formula for an altruistic individual's utility function that includes a term for the consumption of both the individual and the individual's child).

155. Fried, *supra* note 153, at 647. The psychological literature would call this "empathy"

consumption and savings decisions taking into account not only their own needs, but also those of their children.<sup>156</sup>

Gary Becker and Nigel Tomes were the first to model the decision matrix of altruistically-inclined parents.<sup>157</sup> Under their model, parents transfer resources to children in two forms: (1) investments in human capital (which increase the children's wages) and (2) material transfers (which increase the children's wealth and nonwage income).<sup>158</sup> Parents first invest in the child's human capital until the return on education equals that on material capital.<sup>159</sup> Thereafter, the parents' intergenerational transfers take the form of gifts or bequests of material assets.<sup>160</sup> Liquidity-constrained parents will give priority to education transfers where the return is higher, and will transfer material assets only after the optimal amount of human capital has been reached.<sup>161</sup>

The goal of altruistically-inclined parents is to level out consumption between and within generations.<sup>162</sup> Intergenerationally, parents will use material wealth transfers to offset regression toward the mean between their earnings and their children's earnings.<sup>163</sup> Intragenerationally, given different talents and abilities, different children will receive a different mix of the two types of transfers.<sup>164</sup> Overall, under the altruism model, all children will enjoy a standard of living similar to that of their siblings and parents.

Under the Becker and Tomes altruism model, from the parents' perspective, human capital and physical capital transfers are substitutes.<sup>165</sup> This suggests that under a transferor-based tax, such as the gift tax, both types of transfers should be taxed similarly. If, as under current law, only material capital transfers are subject to the gift tax, it may lead to inefficient overinvestment in education and healthcare. Furthermore, intragenerational equity will be disturbed in a perverse way. If, as most models assume, the economic burden

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or "an other-oriented emotional response . . . congruent with the perceived welfare of someone else." C. Daniel Batson et al., *Empathy and Altruism*, in HANDBOOK OF POSITIVE PSYCHOLOGY 485, 486 (C.R. Snyder & Shane J. Lopez eds., 2002).

156. Masson & Pestieau, *supra* note 154, at 62.

157. See Gary S. Becker & Nigel Tomes, *Human Capital and the Rise and Fall of Families*, in BECKER, *supra* note 75, at 257.

158. *Id.* at 263; Masson & Pestieau, *supra* note 154, at 62-63.

159. Masson & Pestieau, *supra* note 154, at 62-63; Becker & Tomes, *supra* note 157, at 274.

160. Masson & Pestieau, *supra* note 154, at 62-63; Becker & Tomes, *supra* note 157, at 274.

161. See Masson & Pestieau, *supra* note 154, at 63. The result for many middle-income parents is that intergenerational transfers are made solely in the form of human capital. See Langbein, *supra* note 129, at 736 (describing this phenomenon in the real world).

162. Masson & Pestieau, *supra* note 154, at 62.

163. See Becker & Tomes, *supra* note 157, at 277.

164. See Masson & Pestieau, *supra* note 154, at 63.

165. See Becker & Tomes, *supra* note 157, at 263 (indicating that "[p]arents must decide how to allocate their total 'bequest' to children between human capital and assets").

of the gift tax is borne by the donee,<sup>166</sup> the less-talented child will find his or her compensatory material wealth transfers reduced by the amount of the tax, whereas the parents' investment in the human capital of the more-talented child will remain unchanged (or will increase). Overall, the child with more ability will receive more from the parents than the child with less ability. Accordingly, if the condition of substitutability exists, both types of wealth transfers should be included in the gift tax base.

Luc Arrondel and André Masson question the substitutability assumption inherent in the altruism model by focusing on the differing effect each type of transfer has on the donee's economic situation.<sup>167</sup> Investments in human capital (education) that come earlier in the donee's life increase the donee's lifetime income.<sup>168</sup> "Financial assistance" to "liquidity-constrained [adult] children" during their early working lives primarily increases the donees' consumption.<sup>169</sup> "Inter vivos transfers . . . received later in life, and tak[ing] the form of stocks rather than regular flows," are a form of early inheritance that increase the child's wealth.<sup>170</sup>

Arrondel and Masson explicitly recognize that their critique of the substitutability assumption is "reminiscent of the Kotlikoff-Modigliani debate."<sup>171</sup> Modigliani includes only the third category of inter vivos transfers (wealth transfers) in his definition of "gratuitous transfers."<sup>172</sup> Kotlikoff, however, includes all three types of transfers (education, assistance, and wealth) in his estimate of gratuitously transferred wealth.<sup>173</sup> Given the differing purposes and timing of the transfers and the differing economic effects on the donee, Arrondel and Masson observe that most economists favor Modigliani's approach because of the "limited degree of substitutability between education transfers and financial assistance, on the one hand, and wealth gifts on the other."<sup>174</sup> It is important to note, however, that unlike

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166. See, e.g., Lily L. Batchelder & Surachai Khitatrakun, *Dead or Alive: An Investigation of the Incidence of Estate Taxes and Inheritance Taxes 2* (3d Annual Conference on Empirical Legal Studies Papers, Oct. 28, 2008), available at <http://ssrn.com/abstract=1134113> (suggesting that the economic burden of wealth transfer taxes is generally borne by the donee).

167. See Luc Arrondel & André Masson, *Family Transfers Involving Three Generations*, 103 SCANDINAVIAN J. ECON. 415, 420-21 (2001).

168. *Id.* at 420.

169. *Id.* Adult children in their early working lives tend to be liquidity-constrained because of imperfect capital or insurance markets. *Id.*

170. *Id.*

171. *Id.*

172. See *id.*; see also *supra* text accompanying note 134.

173. See Arrondel & Masson, *supra* note 167, at 420; see also *supra* note 133 and accompanying text.

174. Arrondel & Masson, *supra* note 167, at 420.

Arrondel and Masson, Modigliani views the situation exclusively from the perspective of the donor, treating college tuition payments as the donor's own consumption and rejecting the human capital characterization as unhelpful.<sup>175</sup>

The Becker and Tomes model of altruism did not play out as expected in the real world.<sup>176</sup> The model's failure to adequately explain gratuitous-transfer behavior led to the rise in importance of the bequest-as-exchange model, which posits that "parents care about some service or action undertaken by their children especially to secure old-age needs, and that the education and bequests are the payment for this service or action."<sup>177</sup> This model assumes some sort of implicit contract between generations based on reciprocity.<sup>178</sup> Interestingly, under this model, the two types of § 2503(e) transfers, education

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175. See Modigliani, *supra* note 120, at 38-39.

176. See Fried, *supra* note 153, at 647-49. The altruism model suggests that donors should gift early and often, rather than transfer assets at death. *Id.* at 648. Empirically, this has not been the case. See James Poterba, *Estate and Gift Taxes and Incentives for Inter Vivos Giving in the US*, 79 J. PUB. ECON. 237, 247 & tbl. 4 (2001) (showing that "taxable gifts comprise a small fraction of the total wealth transferred through estates and gifts"). Moreover, bequests tend to be shared equally rather than calibrated to the economic situation of the donee, which cuts against the altruism model. See Arrondel et al., *supra* note 152, at 112-13 (listing empirical studies suggesting that equal sharing of inheritances is the norm in the United States). Empirical evidence further suggests that inter vivos transfers are positively related to donees' incomes, which also contradicts altruism. Donald Cox, *Motives for Private Income Transfers*, 95 J. POL. ECON. 508, 524-25 (1987). In addition, "several studies find that, among families where parents make transfers to children, a one-dollar increase in parents' resources coupled with a one-dollar reduction in children's resources does not raise transfers by a dollar, although it should under altruism." William G. Gale & Maria G. Perozek, *Do Estate Taxes Reduce Saving?*, in *RETHINKING ESTATE AND GIFT TAXATION* 216, 219 (William G. Gale et al. eds., 2001). The strongest empirical support for altruism remains in wealthy households, suggesting that it may still have relevance in the federal wealth transfer tax area. See Fried, *supra* note 153, at 648 & n.14 (citing studies giving some empirical support to altruism, "particularly among the wealthier income classes").

177. Masson & Pestieau, *supra* note 154, at 68. See generally Donald Cox & Mark R. Rank, *Inter-Vivos Transfers and Intergenerational Exchange*, 74 REV. ECON. & STAT. 305 (1992). The crucial difference between the two models from a public policy perspective is the extent to which public transfers "crowd out" private transfers. *Id.* at 305, 313. If private transfers are motivated by altruism, there will be a high degree of substitution between public and private transfers. See *id.* at 305. On the other hand, if private transfers are motivated by exchange, there will be little or no crowding out. *Id.*

178. Fried, *supra* note 153, at 652; see also Arrondel & Masson, *supra* note 167, at 424-25 (discussing reciprocities in a three-generation model); see also Becker & Tomes, *supra* note 157, at 274.

and healthcare, are linked.<sup>179</sup> Parents pay for their children's education, and in return, adult children support their elderly parents.<sup>180</sup>

Under a long-term view, an exclusion from gift taxation is arguably justified because each party to the implicit contract receives consideration. In other words, under the bequest-as-exchange model, there is no net transfer between generations for the federal wealth transfer taxes to be concerned about. This argument is problematic for several reasons.<sup>181</sup> First, not all education and healthcare transfers are reciprocal. Parents who pay for their children's education may never need financial assistance to pay medical bills later in life. Even if parents do need such support, the children who received the education may not be the same ones who later pay their parents' medical bills. Second, even for reciprocal transfers, the implicit exchange contract is legally unenforceable (barring a legal obligation of support imposed by state law on either side).<sup>182</sup> The obligation is a moral one, and enforcement is limited to the honor system. Unenforceable obligations are not recognized as consideration under the gift tax scheme.<sup>183</sup> Third, the exchange may not be closed for several decades. Under such circumstances, each party's consideration would be received in a different tax year from that of the transfer.<sup>184</sup> The gift tax's annual accounting period cannot accommodate this situation absent a legally enforceable debt obligation.<sup>185</sup> Fourth, the amounts of the respective transfers may be different, leading to a net wealth transfer in one direction subject to gift taxation. Finally, time value of money considerations would need to be accounted for in comparing consideration given and received. For all of these

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179. See Lakshmi K. Raut & Lien H. Tran, *Parental Human Capital Investment and Old-Age Transfers from Children: Is It a Loan Contract or Reciprocity for Indonesian Families?*, 77 J. DEV. ECON. 389, 390-91 (2005) (describing existing models linking parental human-capital investment to old-age transfers from children). Raut and Tran formulated two models of inter vivos transfers linking parental investment in the human capital of children with support transfers from children to elderly parents: the pure loan model and the reciprocity model. *Id.* at 391. Unlike the Becker and Tomes model, which assumes that children are selfish, these models assume two-sided altruism. *Id.* Under the pure loan model, parents determine the level of transfers flowing each way, and cultural and social norms enforce the contract. *Id.* In contrast, under the reciprocity model, children determine how much to transfer to their parents out of pure altruism, independent of considerations of cultural and/or social norms. *Id.* Raut's and Tran's results lend more support to the reciprocity model than to the loan model. *Id.* at 412.

180. *Id.* at 391.

181. As with altruism, the empirical data with regard to exchange models have "generated mixed results." Gale & Perozek, *supra* note 176, at 220.

182. See *supra* text accompanying notes 47-53.

183. See Treas. Reg. § 25.2512-8 (as amended in 1992).

184. The consideration for the child's transfer would be received before the child's transfer, and the consideration for the parents' transfer would be received after the parents' transfer.

185. See I.R.C. § 6019 (2006) (requiring annual gift tax filing).

reasons, the exchange model does not strongly support a broad education and healthcare exclusion such as § 2503(e).

The empirical evidence is mixed with regard to which of these models accurately depicts donor motivations, especially the motives of the wealthiest donors subject to the federal wealth transfer taxes.<sup>186</sup> Donors are likely influenced by a mix of these and other purposes when they decide whether to make a gratuitous transfer.<sup>187</sup> Accordingly, economic models of donor motivation are not a sufficient lodestar to guide one in the determination of whether education and medical transfers should be included in the gift tax base. Moreover, the analysis of donor motivation was premised on a limited interpretation of the backstop function of the gift tax—that only inter vivos wealth transfers that are perfect substitutes for bequests should be included in the gift tax base.<sup>188</sup> A more nuanced interpretation of the role of the gift tax as a backstop to the estate tax, and the one to which this article subscribes, is that the gift tax must rest on normative foundations similar to those of the estate tax.<sup>189</sup> The next section suggests that equality of opportunity and family autonomy are the relevant norms to consider in determining whether education and healthcare transfers should be included in the gift tax base. It frames these competing considerations within a larger debate among liberal egalitarian political theorists about whether the norm of equality of opportunity is incommensurable with the institution of the family.

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186. Gale & Perozek, *supra* note 176, at 221.

187. *See id.* Other models of donor motivation include, inter alia, the capitalistic model (under which very wealthy families “are usually part of a self-sustained accumulation process, children being primarily considered a means of achieving the desired path of wealth accumulation”); the retrospective model (under which one generation bequeaths in an amount and form similar to the inheritance it received, resulting in “bequeathing patterns [that] tend to be reproduced from one generation to the next”); and the paternalistic or bequest-as-consumption model (under which a donor gives because he or she “derives direct utility from the size of the bequest, the latter being simply [a] luxury consumption good”). Arrondel et al., *supra* note 152, at 99. Under another model, called the structural model, pre-estate-tax wealth “may enter the utility function as a separate argument, above and beyond the conventional consumption goods it can finance, because wealth may also provide social status, power, social connections, and so on.” Gale & Perozek, *supra* note 176, at 220.

188. *See supra* notes 148-50 and accompanying text.

189. *See* Fleischer, *supra* note 93, at 267-68 (arguing that estate tax base questions must be resolved by reference to the social policy goals intended to be furthered); *see also* James R. Repetti, *Democracy and Opportunity: A New Paradigm in Tax Equity*, 61 VAND. L. REV. 1129, 1131 (2008) [hereinafter Repetti, *Democracy and Opportunity*] (lamenting that “[t]ax policy has ignored the necessity of first identifying equity goals appropriate for a just government and then designing a tax system to help achieve those goals”).

*V. Equality of Opportunity vs. Family Autonomy*

*A. Fair Equality of Opportunity*

Equality of opportunity, though not defined in the IRC, is one of the core principles supporting the taxation of wealth transfers.<sup>190</sup> As early as 1907, President Theodore Roosevelt advocated a tax on inheritances, arguing that “such a tax would help to preserve a measurable equality of opportunity for the people of the generations growing to manhood.”<sup>191</sup> Yet the contours of this foundational concept remain somewhat blurry.

This article turns to political theory—in particular, liberal egalitarianism—to give content and meaning to the standard of equality of opportunity. Liberal egalitarians recognize the equal moral worth of all individuals, a concept that implies that each individual should have an equal opportunity to pursue his or her own vision of the good.<sup>192</sup> This principle closely aligns with President Roosevelt’s interpretation of the purpose of federal wealth transfer taxes, namely, “that there should be an equality of self-respect and of mutual respect, an equality of rights before the law, and at least an approximate equality in the conditions under which each man obtains the chance to show the stuff that is in him when compared to his fellows.”<sup>193</sup>

There are many different conceptions of equality of opportunity within the liberal egalitarian tradition.<sup>194</sup> This article applies only one version: John Rawls’s “fair equality of opportunity.”<sup>195</sup> According to Rawls, social justice is the manner in which public, or “social,” institutions facilitate fair

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190. See Fleischer, *supra* note 93, at 292; see also Repetti, *Democracy and Opportunity*, *supra* note 189, at 1141-52 (arguing that equality of opportunity is the equity goal that a just government should pursue and that the tax system, in general, should be designed to achieve that goal).

191. 17 WORKS OF THEODORE ROOSEVELT 504-05 (mem’l ed. 1925), *cited in* Eisenstein, *supra* note 20, at 229. Other scholars consider the federal wealth transfer taxes to be supported by the principle of equality of opportunity. See, e.g., Alstott, *Equal Opportunity*, *supra* note 2; James R. Repetti, *Democracy, Taxes, and Wealth*, 76 N.Y.U. L. REV. 825 (2001) [hereinafter Repetti, *Democracy, Taxes*].

192. These respect-based arguments reflect the Kantian roots of the liberal egalitarian tradition. See JOHN RAWLS, *A THEORY OF JUSTICE* 251-57 (1971). Utilitarianism, however, cannot account for a respect-orientated view. See *id.* at 22-27. It is therefore rejected as a baseline principle for federal wealth transfer taxation. See *infra* text accompanying note 193.

193. 17 WORKS OF THEODORE ROOSEVELT, *supra* note 191, at 504-05.

194. See, e.g., AMARTYA SEN, *INEQUALITY REEXAMINED* (1995) (addressing equality of capabilities); Ronald Dworkin, *What Is Equality? Part 2: Equality of Resources*, 10 PHIL. & PUB. AFF. 283 (1981) (discussing equality of resources).

195. See generally RAWLS, *supra* note 192, at 65-90.



participation in plural but limited “primary goods.”<sup>196</sup> “Primary goods” include the fundamental rights and liberties doled out by societal institutions.<sup>197</sup> These are the goods that every rational actor, no matter what his or her vision of the good, would want.<sup>198</sup> The essential primary goods “are rights and liberties, powers and opportunities, income and wealth,” and self-respect.<sup>199</sup>

In his now-famous argument in favor of a public, institutional concept of justice, Rawls articulates two principles of justice to guide institutions in distributing primary goods:

- (1) [e]ach person is to have an equal right to the most extensive total system of equal basic liberties compatible with a similar system of liberty for all, and
- (2) [s]ocial and economic inequalities are to be arranged so that they are both: (a) to the greatest benefit of the least advantaged . . . and (b) attached to offices and positions open to all under conditions of fair equality of opportunity.<sup>200</sup>

The first principle requiring equal liberty is “lexically prior” to the second principle.<sup>201</sup> Rawls calls the second principle the “difference principle.”<sup>202</sup> Assuming fair equality of opportunity, it accepts inequalities in social and economic primary goods provided that such inequality works to the maximum advantage of the worst off in society.<sup>203</sup> Accordingly, fair equality of opportunity is a prerequisite for a distribution of wealth in society that satisfies the demands of justice. The ensuing discussion fleshes out the contours of this baseline principal and its relationship to the federal wealth transfer taxes as a whole, and § 2503(e) in particular.

Fair equality of opportunity includes not only formal equality of opportunity (equal prospects for success given equal talents) but also substantive equality of opportunity (equal life chances to develop equal talents).<sup>204</sup> Formal equality of opportunity prevents intentional discrimination

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196. *See id.* at 7 (stating that “the primary subject of justice is the basic structure of society, or more exactly, the way in which the major social institutions distribute fundamental rights and duties and determine the division of advantages from social cooperation”).

197. *See id.* at 61-62.

198. *Id.* at 62.

199. *Id.*

200. *Id.* at 302.

201. *See id.*

202. *See id.* at 75-83.

203. *See id.* at 75.

204. *See id.* at 73. Formal equality of opportunity can be traced back to Aristotle, who

based on race, sex, religion, or ethnicity.<sup>205</sup> Substantive equality of opportunity results when, “assuming that there is a distribution of natural assets, those who are at the same level of talent and ability, and have the same willingness to use them, . . . have the same prospects of success regardless of their initial place in the social system.”<sup>206</sup>

These two conceptions of equality of opportunity mirror the two types of liberty that modern political theories attempt to juggle, namely, negative and positive liberty. On one hand, equality of opportunity includes an emphasis on negative liberty—the right to be free from the sort of irrational discrimination that undermines merit-based opportunities to participate and succeed in a free market.<sup>207</sup> On the other hand, equality of opportunity requires a positive liberty right of equal access to public goods as a condition of flourishing.<sup>208</sup>

Fair equality of opportunity directs social institutions to take affirmative steps to protect free market arrangements from the various social factors that threaten to undermine citizen participation.<sup>209</sup> In other words, political and legal institutions should counteract, among other things, the effect of socioeconomic background on chances for success in life.<sup>210</sup> Such institutions should remedy hereditary advantage, a type of socioeconomic inequality represented “both in the possession of resources and in access to the means of obtaining qualification for open competitive positions.”<sup>211</sup> Included among these opportunity-ensuring institutions are those related to education and healthcare.<sup>212</sup>

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maintained that similar cases should be treated alike except where there is some relevant difference. JOHN ARTHUR & WILLIAM H. SHAW, *JUSTICE AND ECONOMIC DISTRIBUTION* 3 (2d ed. 1991). As Rawls indicates, however, treating similar cases similarly is not a sufficient guarantee of substantive justice. *See* RAWLS, *supra* note 192, at 72-73; *see also* FISHKIN, *supra* note 12, at 4-5 (describing equal opportunity as requiring fair competition among individuals for unequal positions in society, which entails adopting the assumptions of procedural fairness (principle of merit) and substantive fairness (principle of equal life chances)).

205. *See* NAGEL, *supra* note 12, at 102.

206. RAWLS, *supra* note 192, at 73.

207. *See generally* Isaiah Berlin, *Two Concepts of Liberty*, in ISAIAH BERLIN, *FOUR ESSAYS ON LIBERTY* 118 (1969).

208. *See id.*

209. *See* RAWLS, *supra* note 192, at 73 (specifying that “free market arrangements must be set within a framework of political and legal institutions which . . . preserves the social conditions necessary for fair equality of opportunity”).

210. *See id.*

211. NAGEL, *supra* note 12, at 102. Nagel calls substantive equality of opportunity “positive equality of opportunity.” *Id.* at 102-03 (emphasis omitted).

212. *See* Marjorie E. Kornhauser, *Choosing a Tax Rate Structure in the Face of Disagreement*, 52 *UCLA L. REV.* 1697, 1730 (2005) (contending that equality of opportunity

Rawls is most explicit with regard to education, indicating that society must ensure “equal opportunities of education for all.”<sup>213</sup> Fair equality of opportunity requires “equal chances of education and culture for persons similarly endowed and motivated,” regardless of family background.<sup>214</sup> Stated differently, Rawls envisions the school system serving as a class equalizer.<sup>215</sup> This view implies that to the greatest extent possible, “the quality of education received by each child should be independent of the level of wealth, education, and wise choice-making ability of his or her parents.”<sup>216</sup> Rawls also considers education instrumental in securing the primary goods of liberty and self-respect.<sup>217</sup> Individuals cannot meaningfully exercise their liberty rights and participate in democracy if they lack the basic capabilities to make informed decisions that education provides.<sup>218</sup>

Norman Daniels eloquently argues that healthcare, like education, is part of the “framework” of social institutions designed to “preserve[] the . . . conditions necessary for fair equality of opportunity.”<sup>219</sup> Specifically, he contends that adequate healthcare “maintain[s] normal species functioning, and

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requires “people [to] have access to resources such as healthcare, housing, and education”).

213. RAWLS, *supra* note 192, at 73.

214. *Id.* at 275.

215. *See id.* at 73. Specifically, Rawls argues that “[c]hances to acquire cultural knowledge and skills should not depend upon one’s class position, and so the school system, whether public or private, should be designed to even out class barriers.” *Id.* Other liberal egalitarians share this view. *See, e.g.,* Alstott, *Equal Opportunity*, *supra* note 2, at 477; Alstott, *Family at Odds*, *supra* note 12, at 6-7; Harry Brighouse, *Why Should States Fund Schools?*, 46 BRIT. J. EDUC. STUD. 138 (1998).

216. Brighouse, *supra* note 215, at 138; *see also* Alstott, *Family at Odds*, *supra* note 12, at 26. Alstott explains that

[a] system of equal liberal education might, in principle, cultivate each child’s academic potential [regardless of class background] as well as her talents via extracurricular activities. These schools would (again, in principle) help every child explore different ways of life and would introduce children to adults working in jobs and pursuits of interest to ensure that each child entered adult life with a social network.

*Id.*

217. *See* RAWLS, *supra* note 192, at 101 (stating that education helps to “enabl[e] a person to enjoy the culture of his society and to take part in its affairs, and in this way to provide for each individual a secure sense of his own worth”). Rawls also explains that “resources for education are not to be allotted solely or necessarily mainly according to their return as estimated in productive trained abilities, but also according to their worth in enriching the personal and social life of citizens, including here the less favored.” *Id.* at 107.

218. *See* Kornhauser, *supra* note 212, at 1735-36 & n.82 (citing studies that show that people with lower education levels do not participate in the political process as much as those with higher education levels).

219. *See supra* note 209.

in turn, such normal functioning is an important determinant of the range of opportunity open to an individual.<sup>220</sup> When normal functioning is impaired by disease or disability, the range of opportunities that would otherwise be available is restricted.<sup>221</sup> Daniels extends Rawls's fair equality of opportunity concept by reasoning that "if it is important to use resources to counter the advantages . . . some get in the natural lottery, it is equally important to use resources to counter the natural disadvantages induced by disease."<sup>222</sup> Daniels concludes that justice requires "universal access to appropriate healthcare."<sup>223</sup>

Under Rawls's theory, the federal wealth transfer taxes serve as backstops to opportunity-ensuring social institutions, protecting fair equality of opportunity when excessive wealth inequalities impede these institutions' effectiveness.<sup>224</sup> Rawls argues that government should levy estate and gift taxes, "not to raise revenue[,] . . . but gradually and continually to correct the distribution of wealth and to prevent concentrations of power detrimental to the fair value of political liberty and fair equality of opportunity."<sup>225</sup> Thus, Rawls explicitly recognizes that excessive wealth inequalities can jeopardize fair equality of opportunity and that the wealth transfer taxes perform the crucial function of preventing dangerous accumulations of wealth.<sup>226</sup>

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220. Norman Daniels, *Health-Care Needs and Distributive Justice*, 10 PHIL. & PUB. AFF. 146, 147 (1981) [hereinafter Daniels, *Health-Care Needs*];

221. Norman Daniels, *Justice, Health, and Healthcare*, AM. J. BIOETHICS, Spring 2001, at 2, 3-4 [hereinafter Daniels, *Justice, Health*].

222. Daniels, *Health-Care Needs*, *supra* note 220, at 166. Daniels also recognizes that Rawls's emphasis on fairness in the competition for jobs and offices introduces an age bias into the concept of equality of opportunity because the elderly are no longer part of that competition. Daniels, *Justice, Health*, *supra* note 221, at 4-5. To counteract this, he argues that an individual's normal opportunity range should be age-relative. *Id.* at 5; *see also* Daniels, *Health-Care Needs*, *supra* note 220, at 170-71. Specifically, he argues that fair allocation of health resources between age groups should be based on the idea of "prudent allocation over a life span." Daniels, *Justice, Health*, *supra* note 221, at 5. He suggests that designers of a healthcare system subjected to a situation similar to Rawls's veil of ignorance would conclude after "prudent deliberation" that institutions should be designed "to assure individuals a fair chance at enjoyment of the normal opportunity range for each life-stage." Norman Daniels, *Justice Between Age Groups: Am I My Parents' Keeper?*, 61 MILBANK MEMORIAL FUND Q., HEALTH & SOC'Y 489, 510 (1983).

223. Daniels, *Justice, Health*, *supra* note 221, at 4 (defining "appropriate healthcare" to include "traditional public health[care] and preventive measures—through public or mixed public and private insurance schemes").

224. *See* RAWLS, *supra* note 192, at 278 ("It is these institutions that are put in jeopardy when inequalities of wealth exceed a certain limit; and political liberty likewise tends to lose its value, and representative government to become such in appearance only.").

225. *Id.* at 277.

226. *Id.* at 277-78. Here, Rawls is explicitly worried about outcomes, but only to the extent that they undermine public institutions. *See id.*

It is helpful here to explain exactly how excessive inequalities in wealth pose a threat to fair equality of opportunity, including opportunities for education and healthcare. If the wealthy elite of a society opt out of the basic system by purchasing more or better education or healthcare, then economic and political support for the basic system may be undermined.<sup>227</sup> James Repetti argues that wealth concentration is harmful to democracy because it “enable[s] wealthy individuals to influence disproportionately the elective and legislative process, as well as their communities.”<sup>228</sup> Co-option of the political process by the wealthiest in society violates Rawls’s first principle of justice, equal liberty for all.<sup>229</sup> Moreover, if those in control of the political process do not have a direct personal interest in the success of basic education and healthcare institutions, the political will to deal with issues of access, quality, and funding may be lacking. As a result, society will make inadequate investments in the human capital of its poorest members, violating Rawls’s second principle of justice that allows inequalities of opportunity only if they work to the advantage of the worst off in society.<sup>230</sup> The state of the public school systems in urban city centers provides a good example of the type of harm that opt out can wreak. As wealthy families have removed their children from urban public schools by sending them to private schools (or by moving to the suburbs), the basic public school system has steadily deteriorated.<sup>231</sup>

Rawls’s account of fair equality of opportunity raises several important objections to the exclusion of education and healthcare transfers from the gift tax base under § 2503(e). Education and healthcare cannot offset the effects of family background and help maintain normal species functioning if access to these institutions is itself stratified by socioeconomic class.<sup>232</sup> Unequal

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227. See NORMAN DANIELS ET AL., *BENCHMARKS OF FAIRNESS FOR HEALTHCARE REFORM* 27-28 (1996) (analyzing the issue of whether fairness in healthcare is compatible with a “tiered” healthcare system). The authors conclude that tiering in healthcare is acceptable only if the basic tier is not undermined economically or politically by the existence of higher tiers, and if the inequality results in a system like the British system wherein most are served by the basic tier and only the most fortunate in society purchase supplementary insurance, rather than a system in which only the poor are served by the basic tier while the majority purchase supplemental insurance. See *id.*

228. Repetti, *Democracy, Taxes*, *supra* note 191, at 849.

229. See RAWLS, *supra* note 192, at 302.

230. See *id.* Repetti also argues that inequality in opportunities will result in decreased economic growth over the long term. See Repetti, *Democracy, Taxes*, *supra* note 191, at 838-40.

231. See FISHKIN, *supra* note 12, at 71 (discussing the inadequacy of the public school system as an institution ensuring positive equality of opportunity).

232. See *supra* text accompanying notes 213-18 (outlining Rawls’s argument that education is needed to offset the effects of family background) and 217-21 (outlining Daniels’s argument that adequate healthcare is needed to ensure that one’s normal opportunity range is not impaired).

access to opportunity-ensuring institutions tends to solidify and potentially magnify any existing inequalities in the distribution of wealth and income, thereby frustrating the wealth-leveling goals of the federal wealth transfer taxes.<sup>233</sup> Furthermore, by exempting private education and healthcare transfers, § 2503(e) encourages the wealthiest in society to opt out of the basic system, thereby putting at risk that system's political and economic support. Thus, from an equality of opportunity perspective, human capital transfers may be *more* problematic than material wealth transfers. As one commentator remarked, "[I]t is fairly reasonable to assume that education is more important for success in life than an inheritance received at the age of 45."<sup>234</sup>

Proponents of § 2503(e) may counter by arguing that to the extent that superior access to education and healthcare makes the wealthy more productive, the economy will grow and everyone will be better off. This argument, however, misunderstands Rawls's second principle of justice.<sup>235</sup> It is not a philosophical version of "trickle-down" economics.<sup>236</sup> Rather, the difference principle "requires a maximal flow downward" so that over time socioeconomic inequalities are flattened "in a robust way."<sup>237</sup>

Furthermore, empirical data belie the claim that everyone benefits when the economy grows. From 1989 to 2001, Gross Domestic Product (GDP) grew in real terms 41.67%.<sup>238</sup> Household wealth at the end of 2001 was almost 50% higher than the level in 1989.<sup>239</sup> This wealth, however, remained highly concentrated and unequally distributed. As of 2001, households in the top 1% of the wealth distribution held 32.7% of the total wealth in the economy, and those in the top 5% held 57.7%.<sup>240</sup> On the other end of spectrum, households

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by disease or disability).

233. See *supra* text accompanying notes 227-31.

234. Toon Vandeveld, *Inheritance Taxation, Equal Opportunities and the Desire of Immortality*, in IS INHERITANCE LEGITIMATE?, *supra* note 152, at 1, 4.

235. See RAWLS, *supra* note 192, at 302.

236. Daniels, *Justice, Health*, *supra* note 221, at 8. The "trickle-down theory" holds "that societal welfare can be increased by focusing on economic policies that raise everyone's incomes, without regard for distributional concerns." ICHIRO KAWACHI & BRUCE P. KENNEDY, *THE HEALTH OF NATIONS: WHY INEQUALITY IS HARMFUL TO YOUR HEALTH* 56 (2002).

237. Daniels, *Justice, Health*, *supra* note 221, at 8.

238. The author's calculation of this figure is based on data from the U.S. Commerce Department's Bureau of Economic Analysis. See Bureau of Econ. Analysis, U.S. Dep't of Commerce, Current-Dollar and "Real" Gross Domestic Product (2009) (unpublished table) (real GDP measured in chained 2000 dollars), available at <http://www.bea.gov/national/xls/gdplev.xls>.

239. Arthur B. Kennickell, *A Rolling Tide: Changes in the Distribution of Wealth in the U.S., 1989-2001*, at 1 (Levy Econ. Inst. of Bard Coll., Working Paper No. 393, 2003), available at <http://www.levy.org/pubs/wp393.pdf>.

240. *Id.* at 9 tbl.5.

in the lowest fiftieth percentile of the wealth distribution held just 2.8% of the total wealth in the economy.<sup>241</sup> In 2001, the least advantaged families (more than 10% of total families) had little or no assets.<sup>242</sup> Income has also been unequally distributed over the last quarter century, though it has not been as concentrated as wealth.<sup>243</sup>

The utilitarian argument that everyone will be better off if education and healthcare are concentrated in the wealthy also fails when applied to Rawls's rights-based approach under which fair equality of opportunity precedes or has priority over the difference principle.<sup>244</sup> According to Rawls, outcomes will satisfy the difference principle only assuming "fair equality of opportunity underwritten by education for all; and that the other equal liberties are secured."<sup>245</sup> Moreover, he states that consistency with "the priority of fair opportunity over the difference principle" means that

it is not enough to argue . . . that the whole of society including the least favored benefit from certain restrictions on equality of opportunity. We must also claim that the attempt to eliminate these inequalities would so interfere with the social system and the operations of the economy that in the long run anyway the opportunities of the disadvantaged would be even more limited. The priority of fair opportunity . . . means that we must appeal to the chances given to those with the lesser opportunity.<sup>246</sup>

In other words, "[t]he claim . . . must be that the opportunities of the least favored sectors of the community would be still more limited if these inequalities were removed."<sup>247</sup>

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241. *Id.*

242. *See id.* at 9 tbl.4.

243. *See* MICHAEL STRUDLER ET AL., STATISTICS OF INCOME DIV., IRS, FURTHER ANALYSIS OF THE DISTRIBUTION OF INCOME AND TAXES, 1979-2002, at 2-3 (2004), <http://www.irs.gov/pub/irs-soi/04asastr.pdf>. Strudler and his colleagues calculate that "[t]he share of income accounted for by the top 1 percent of the income distribution has climbed steadily from a low of 9.58 percent . . . for 1979 to a high of 21.55 [percent] . . . for 2000." *Id.* at 2. Moreover, "[t]his pattern of an increasing share of total income is mirrored in the 1-to-5 percent class but to a considerably lesser degree," increasing from "12.60 percent to 15.14 percent in this period." *Id.* at 3. During this same period, "the shares of the lower percentile-size classes, from the [top] 10-to-20 percent classes to the four lowest quintiles, show declines in shares of total income." *Id.*

244. *See* RAWLS, *supra* note 192, at 302-03; *see also* Brighthouse, *supra* note 215, at 142 (describing the priority of equality of opportunity over the difference principle under Rawls's theory).

245. RAWLS, *supra* note 192, at 87.

246. *Id.* at 300-01.

247. *Id.* at 302.

Accordingly, inequalities of opportunity in education and healthcare fostered by § 2503(e) cannot be justified by the possibility that the share of economic and social benefits for the least advantaged in society will be increased.<sup>248</sup> A stronger claim would be that any attempt to tax human capital transfers undermines the legitimacy of the federal wealth transfer tax system as a whole and may lead to its eventual demise.<sup>249</sup> The inequalities of opportunity that would result in a society without the protection of a federal wealth transfer tax system are far worse than those that come from exempting human capital transfers from taxation. The next subsection of this article outlines a theory of why attempting to tax human capital transfers under the gift tax may put the legitimacy of the entire wealth transfer tax system at risk.

### *B. Family Autonomy*

There is an inherent tension between the norm of equality of opportunity and the institution of the family.<sup>250</sup> Even if society could achieve fair equality of opportunity (in the sense of equal access to opportunity-ensuring institutions), equality of life chances would not necessarily result because an individual's ability to utilize the provided resources might be limited (or enhanced) by socioeconomic background. Rawls explicitly recognizes this:

[T]he principle of fair opportunity can be only imperfectly carried out, at least as long as the institution of the family exists. The extent to which natural capacities develop and reach fruition is affected by all kinds of social conditions and class attitudes. Even the willingness to make an effort, to try, and so to be deserving in the ordinary sense is itself dependent upon happy family and social circumstances. It is impossible in practice to secure equal chances of achievement and culture for those similarly endowed.<sup>251</sup>

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248. Brighthouse, *supra* note 215, at 142 (making this argument with regard to education specifically).

249. This argument is more than hypothetical. The repeal of the estate and generation-skipping transfer taxes under EGTRRA was engineered by a few grassroots taxpayers with strong feelings about the legitimacy of the federal wealth transfer tax system. See generally MICHAEL J. GRAETZ & IAN SHAPIRO, *DEATH BY A THOUSAND CUTS: THE FIGHT OVER TAXING INHERITED WEALTH* (2005).

250. For purposes of this article, the term "family" is given the broadest possible meaning and specifically includes "a community composed of a child and one or more adults in a close affective and physical relation." FISHKIN, *supra* note 12, at 36 (citing JOHN E. COONS & STEPHAN D. SUGARMAN, *EDUCATION BY CHOICE: THE CASE FOR FAMILY CONTROL* 53 (1978)); accord Alstott, *Family at Odds*, *supra* note 12, at 15 (discussing one theory under which family "need not be defined by biological relationship between parent and child or by marriage (or a sexual relationship) between parents").

251. RAWLS, *supra* note 192, at 74. Rawls's solution to the effect of family on equality of



Even if we completely abolished material inheritance, differences in family background would still result in imperfect realization of the equality of opportunity ideal.<sup>252</sup>

James Fishkin characterizes this conflict as a specific instance of a more general conflict between liberty (autonomy of the family) and equality (formal and substantive equality of opportunity).<sup>253</sup> He describes a “trilemma” in liberal theory in which society cannot simultaneously recognize parents’ liberty interests in substantially influencing the development of their children and achieve both substantive and formal equality of opportunity.<sup>254</sup> He suggests that only two of these goals can be satisfied at any given time.<sup>255</sup> Under his scheme, substantive and formal equality of opportunity can only be achieved by sacrificing family autonomy.<sup>256</sup> Specifically, he argues that “[c]oercive interferences with the family would be required if advantaged parents were to be prevented, systematically, from passing on cognitive, affective, cultural, and social advantages to their children.”<sup>257</sup> He takes the extreme position that “[e]ither systematic intrusions into the family would be required to equalize developmental conditions despite unequal outcomes or the

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opportunity is the difference principle, which allows residual family inequalities to exist provided that such inequalities improve the expectations of the least advantaged in society. *See id.* at 75-79; *see also supra* text accompanying notes 200-03.

252. *See* NAGEL, *supra* note 12, at 102. Thomas Nagel recognizes that “so long as children grow up in families, they will inevitably benefit or suffer from the advantages or disadvantages of their parents, even if inheritance of property at death is considerably restricted.” *Id.* Nagel suggests that such effects can be mitigated, at least in part, “by public support for childcare, education and the like.” *Id.*

253. *See* FISHKIN, *supra* note 12, at 8-9, 158-60. Fishkin describes autonomy of the family as both a positive liberty interest (allowing a family to govern “the physical and psychological health of the child and his or her knowledge of those social conventions necessary for participation in adult society”) and, drawing on Mill’s harm principle, a negative liberty interest (“[s]o long as no one is severely harmed, intimate consensual relations[, including those of the family,] should be immune from coercive interference”). *Id.* at 36, 42; *see also* Alstott, *Family at Odds*, *supra* note 12, at 6 (identifying the family as “a sphere of negative liberty”).

254. *See* FISHKIN, *supra* note 12, at 44; *see also* Michael B. Levy, *Liberal Equality and Inherited Wealth*, 11 *POL. THEORY* 545, 555 (1983) (noting that under “a Rawlsian framework, both reward to merit and equality of full opportunity conflict with family life—the former because we are often rewarded for the accident of good birth, and the latter because such accidents will inevitably exist as long as there are children with different parents”).

255. FISHKIN, *supra* note 12, at 5, 44.

256. *Id.* at 50.

257. *Id.* at 64-65 (suggesting that “[p]erhaps a massive system of collectivized child-rearing could be devised to achieve such a result”).

whole liberal focus on equality of opportunities, as distinct from equal outcomes, would have to be abandoned.”<sup>258</sup>

Fishkin also describes the conflict between family autonomy and equality of opportunity as part of a larger conflict between “conventional morality and systematic liberal theory.”<sup>259</sup> Thomas Nagel characterizes this latter conflict as a clash between partiality and impartiality, or between the personal and the impersonal.<sup>260</sup> Nagel theorizes that within every individual there are two points of view that potentially conflict.<sup>261</sup> The first is the collective-based, impartial or impersonal viewpoint that tends toward equality.<sup>262</sup> The second is the personal perspective that “gives rise to individualistic motives and requirements which present obstacles to the pursuit and realization of such [collective] ideals.”<sup>263</sup> According to Nagel, “If an arrangement is to claim the support of those living under it—if it is to claim legitimacy, in other words—then it must rely on or call into existence some form of reasonable integration of the elements of [individuals’] naturally divided selves.”<sup>264</sup>

Nagel applies his theory to the problem of inequality resulting from hereditary advantage.<sup>265</sup> The clash there is between the societal norm of equality of opportunity and the special, personal interest that people take in providing for those closest to them.<sup>266</sup> He argues that prohibiting nepotism is one step favoring the impartial over the personal.<sup>267</sup> Society’s insistence on substantive equality of opportunity moves the line one more notch toward the impersonal.<sup>268</sup> Federal taxes on gratuitous transfers of material wealth presumably inch the line yet another step toward the impersonal side of the spectrum. There remains, however, a very large category of residual inequalities owing to family circumstances, the approach to which defines the

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258. *Id.* at 4. Fishkin suggests that the trilemma only exists under conditions of substantial social and economic inequalities. *Id.* at 50. Under his account, the conflict disappears once one relaxes the assumption that such conditions exist. *Id.* He concludes that this means that liberal theory is “far more radical” than it claims because it seeks to equalize results or outcomes rather than only opportunities. *Id.* at 50-51.

259. *Id.* at 43.

260. *See* NAGEL, *supra* note 12, at 3-4.

261. *See id.*

262. *Id.* at 4.

263. *Id.*

264. *Id.*

265. *See id.* at 102.

266. *See id.* at 109-10 (suggesting that “[t]here is no possibility of abolishing this interest, and no sane person would wish to do so”).

267. *See id.* at 110; *cf.* FISHKIN, *supra* note 12, at 37 (advancing a definition of family autonomy limited to choices regarding child development, thereby excluding the practice of nepotism from the concept).

268. *See* NAGEL, *supra* note 12, at 110-11.

“modern liberal mentality.”<sup>269</sup> Nagel describes the modern liberals’ motivational split as follows:

[E]ven if such persons support the public provision of education and health care for all, . . . they will not stop favoring their children in their more personal choices. If they have the resources, they will continue to offer whatever extra advantages they can, by paying for superior education, by direct cultural enrichment, and by various forms of financial support. While these things are good in themselves, they also aim to give the child a competitive edge.<sup>270</sup>

The question is, how much farther can societal institutions, including the federal wealth transfer taxes, push the line toward impartial equality without generating pushback from the personal side that “will inevitably invade the political sphere”?<sup>271</sup> Prior to ERTA, there was strong taxpayer opposition to correcting inequities resulting from differences in family background by regulating through taxation parents’ ability to provide private education for their children or healthcare for their elderly relatives. Taxpayer sentiment on this issue was presented to Congress during the hearings leading up to enactment of § 2503(e). The then-chairman and chairman-elect of the American Bar Association’s Section of Taxation argued, “[M]ost taxpayers do not regard [expenditures for education and support for aged relatives] as gifts and do not report them for gift tax purposes. Furthermore, it is doubtful that taxpayers can ever be convinced to treat such transfers as ‘gifts.’”<sup>272</sup> Another witness testified that “[m]ost people aren’t aware that . . . payment of [education] expenses for a child to whom no support obligation is owed constitutes a gift. That notion is very offensive to me and to all of my clients. . . . I can almost guarantee you they are not going to file a gift tax return.”<sup>273</sup> Even as far back as 1969, the ALI identified as problematic the fact that most families did not consider human capital transfers to be gifts.<sup>274</sup> In proposing its solution, the ALI indicated that it was “responding to normal family reactions in regard to intra-family movement of property.”<sup>275</sup>

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269. *Id.* at 111.

270. *Id.*

271. *Id.* at 111-12.

272. *Hearing, supra* note 108, at 176.

273. *Id.* at 150, 151 (statement of Malcolm A. Moore, Probate and Trust Division Director, Section of Real Property, Probate and Trust Law, American Bar Association).

274. *See* Am. Law Inst., *supra* note 50, at 20.

275. *Id.*

Pre-ERTA opposition to the gift taxation of education and healthcare transfers led to “large-scale violations of gift tax filing requirements.”<sup>276</sup> Compounding this problem was a lack of enforcement by the IRS.<sup>277</sup> This situation undermined taxpayer respect for the federal wealth transfer tax system as a whole.<sup>278</sup> Our tax system relies on self-reporting, and its success depends in part on taxpayers’ view of it as legitimate.<sup>279</sup> The federal gift tax is notoriously difficult to enforce, making legitimacy particularly important as a promoter of voluntary compliance.<sup>280</sup> Thus, lack of congressional recognition of the personal motivations behind human capital transfers impaired the ability of the federal wealth transfer tax system to achieve its wealth-leveling goals.

### *VI. Alternative Proposal*

That § 2503(e) can be justified as an accommodation to family autonomy within the federal wealth transfer tax system does not end the analysis, for family autonomy can run counter to the opportunity-equalizing goals of the federal wealth transfer taxes.<sup>281</sup> Lawmakers must actively wrestle with the issue of where to draw the line between impartial equality and partial family

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276. Ray, *supra* note 47, at 427; *see also id.* at 444-45 (delineating then-existing sanctions for knowing and unknowing violations of the federal gift tax filing and payment requirements).

277. *See id.* at 427 (speculating that the lack of IRS enforcement was due to “low potential current revenue yield, likely unpopularity of such efforts, and adverse congressional reaction”); *see also* Gutman, *supra* note 34, at 1242. This set of circumstances placed estate planning advisors in the uncomfortable position of having to inform their clients that these transfers were technically gifts, knowing that unadvised individuals would simply fail to report them with virtually complete immunity. *See* Popovich, *supra* note 64, at 371-72.

278. *See Hearing, supra* note 108, at 319 (statement of Robert M. Bellatti, Chairman, Illinois State Bar Association that “[i]mposing tax consequences on these common parental expenditures [for education and healthcare] erodes the citizen’s respect for the entire transfer tax system”).

279. *See* Kornhauser, *supra* note 212, at 1737 (positing that “[p]eople willingly pay tax only if they think the tax is legitimate both in terms of originating from a fair process and in terms of resulting in a just outcome (spreading the tax burden in a fair manner”).

280. *See generally* Mitchell M. Gans & Jay A. Soled, *Reforming the Gift Tax and Making It Enforceable*, 87 B.U. L. REV. 759 (2007). Compliance with the reporting and payment requirements of the estate tax is heightened, as compared to the gift tax, because the estate tax is embedded within the larger legal process of administering the decedent’s estate. This larger legal process is subject to state-law requirements, is overseen by a fiduciary, and includes multiple interested parties who all have competing claims on the decedent’s assets. These factors tend to ensure the integrity of the administration process and of the estate tax filing and payment requirements as a by-product. By contrast, inter vivos intrafamily gifts occur in private, outside of any organized legal process.

281. *See* discussion *supra* Part V.B.

interests. As Murphy and Nagel recognize, this is not an easy task given that “the motives of justice and self-interest may not point in the same direction . . . and [that] the process of finding an accommodation between them poses some of the hardest problems of ethics, political theory, and practical politics.”<sup>282</sup>

At first blush, it appears that these competing values are incommensurable: either the state protects equality of opportunity at the expense of family autonomy or it protects the latter at the expense of the former. While some scholarship suggests that these two liberal values can be integrated,<sup>283</sup> Congress’s “all-or-nothing” approach to the gift taxation of these transfers suggests that it has implicitly adopted the incommensurability view. Prior to 1981, Congress elevated positive equality of opportunity over family autonomy by taxing all education and healthcare transfers.<sup>284</sup> Reversing course, under ERTA Congress excluded all tuition and medical expense payments from gift taxation, promoting family autonomy but failing to respect the demands of equality of opportunity.<sup>285</sup>

Given that these foundational principles conflict, an “all-or-nothing” legislative approach is inappropriate. Rather, Congress should attempt to balance these competing interests by adopting a “middle-ground” approach to the taxation of human capital transfers. This section proposes an alternative to the unlimited gift tax exclusion for tuition and medical care payments. Specifically, Congress should convert § 2503(e) into a gift tax credit available *after* application of the unified credit. This approach effectively includes education and healthcare transfers in the gift tax base (furthering equality of opportunity) but prevents such inclusion from ever causing a gift tax to be due and payable (recognizing family autonomy concerns).

Recall that the current exclusion removes education and healthcare transfers entirely from the gift tax base and is available in addition to the annual and

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282. LIAM MURPHY & THOMAS NAGEL, *THE MYTH OF OWNERSHIP: TAXES AND JUSTICE* 178 (2002).

283. Compare FISHKIN, *supra* note 12, at 5, 44, with Alstott, *Family at Odds*, *supra* note 12, at 19-20 (arguing that in theory, equality of opportunity can coexist with parental autonomy if we split the parental functions between the parents and the liberal state, with the family held responsible for the child’s emotional needs and well-being, and the liberal state held responsible for the child’s material needs), and Levy, *supra* note 254, at 555 (suggesting that these values are incommensurable only under utopian liberal egalitarian theory and recommending a more pragmatic approach that would “continue to lessen those effects of family life which prevent all from better realizing their natural talents, without eliminating the family itself, [so that] values such as equality of opportunity and merit continue to be useful and legitimate”).

284. See *supra* notes 29-30 and accompanying text.

285. See Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 441(b), 95 Stat. 172, 319 (codified as amended at I.R.C. § 2503(e) (2006)).

lifetime exemption amounts.<sup>286</sup> Outright repeal of § 2503(e) would cause human capital transfers to be subject to gift taxation in the same manner as material gifts, meaning that such transfers could pass tax-free only if sheltered by the annual exclusion or unified credit (lifetime exemption equivalent).<sup>287</sup> The effect of converting § 2503(e) into a tax credit available after application of the unified credit would be the same as outright repeal up until exhaustion of the lifetime exemption amount.<sup>288</sup> Thereafter, however, a donor's additional material transfers would cause a gift tax to be payable, but additional education and healthcare transfers would remain gift tax-free because of the proposed tax credit.<sup>289</sup>

The practical effect of the proposal, then, is to force a donor to use his or her general gift tax exemptions to shelter education and medical care transfers, thereby reducing the amount of tax-free material transfers that he or she can make.<sup>290</sup> This approach recognizes that human capital transfers pose as much,

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286. *See supra* notes 38-41 and accompanying text.

287. *See supra* notes 52-54 and accompanying text.

288. Obviously, ordering rules would need to be devised to deal with how the unified credit and the education/medical expense credit would be applied to the various transfers (material and human capital) made in the year when the unified credit was exhausted. One option would be to apply the credits sequentially (unified credit followed by education/medical expense credit) to the different types of transfers in the order in which they were made. This approach would make the timing of the various transfers crucially important and might be subject to manipulation by taxpayers. Alternatively, the unified credit could be automatically applied to material transfers, and any remaining unified credit plus the education/medical expense credit applied to any human capital transfers. This option would be the most taxpayer friendly. A final option would be to apply the credits based on the proportion of each type of transfer made during the year of exhaustion of the unified credit.

289. One legitimate administrative concern with this proposal is the increased gift tax return filing that would be necessitated by inclusion of education and medical care payments in the tax base. To the extent that such transfers exceeded the annual exclusion in any given year, a gift tax return would be necessary to shelter such transfers under either the donor's unified credit or the proposed education/medical expense credit. *See* I.R.C. § 6019 (2006); *see also supra* note 54 and accompanying text. The burden on taxpayers could be substantially reduced if available electronic filing software produced gift tax returns in addition to income tax returns. Alternatively, gift tax reporting could be accommodated on the individual income tax return (Form 1040), negating the need to file a separate gift tax return. *Cf.* Dodge, *Replacing the Estate Tax*, *supra* note 62, at 1023 (suggesting that any tax owed by transferees under a cumulative lifetime accessions tax be reported on a separate line of the individual income tax return, and suggesting that the IRS keep track of cumulative lifetime accessions on behalf of all taxpayers). In either case, the real increased burden would fall on the IRS.

290. One potential problem with the proposal is the ability of an ultrawealthy donor to strategically avoid it by initially transferring up to the lifetime exemption amount to a trust and thereafter making education and healthcare payments as needed. This would put the donor in the same tax position as he or she would be in under current law. The proposal would then tend to impact only the "merely" wealthy because they would be unable to part with such a large sum

if not more, of a threat to fair equality of opportunity as do material transfers.<sup>291</sup> Accordingly, the proposal generally treats both types of transfers similarly for gift tax purposes. In doing so, it implicitly adopts the Kotlikoff/Becker and Tomes view that from the donor's perspective, human-capital and material transfers are substitutes.<sup>292</sup> Treating them as such enhances overall progressivity in the gift tax system by generally taxing all donors at increasingly higher marginal rates as their total (human and nonhuman) transfers increase.<sup>293</sup> Increasing the progressivity in the federal wealth transfer system assists in reducing concentrations of wealth that threaten equality of opportunity.<sup>294</sup> The proposal generally rejects the Arrondel and Masson view that human capital transfers are qualitatively different from material transfers and the implication that this difference should matter from a gift tax perspective.<sup>295</sup>

Forcing a donor to use his or her general gift tax exemptions to shelter human capital transfers seems appropriate in light of the role of these exemptions in the federal wealth transfer tax scheme. In designing the gift and estate taxes, Congress implicitly recognized the need to allow reasonable space for tax-free expression of personal motives. In particular, the annual gift tax exclusion and the unified credit against gift tax serve family-autonomy-furthering functions,<sup>296</sup> especially at their current elevated levels,<sup>297</sup> which allow a living donor to more than adequately maintain his or her family. Furthermore, the increased unified credit available for estate tax purposes under EGTRRA allows a donor to leave an additional (more than reasonable)

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of money early on (they would need it for themselves), but would ultimately have taxable estates. I am indebted to Kenneth Halcom for making this point to me.

291. See discussion *supra* Part V.A.

292. See *supra* notes 131-33, 165 and accompanying text.

293. See I.R.C. §§ 2010(c), 2505 (2006). Under EGTRRA, in 2010, the gift-tax rate schedule converts from a progressive rate schedule to a flat rate schedule. See *id.* § 2505; cf. Michael J. Graetz, *To Praise the Estate Tax, Not to Bury It*, 93 YALE L.J. 259, 269-273 (1983) (arguing that the federal wealth transfer taxes provide a desirable degree of progression to the entire federal tax system); Maureen A. Maloney, *Distributive Justice: That Is the Wealth Tax Issue*, 20 OTTAWA L. REV. 601, 611 (1988) (arguing that the "most powerful arguments in favour of some type of wealth taxation are based on ensuring progressivity and enhancing equality of opportunity").

294. See *supra* notes 227-31 and accompanying text.

295. See *supra* notes 167-73 and accompanying text.

296. See Smith, *supra* note 27, at 401 (suggesting that one of the functions of the annual exclusion is to protect "normal family and friend-type gifts from taxation and reporting").

297. See I.R.C. §§ 2010(c), 2505 (2006) (providing that in 2009 the applicable exclusion amount for gift tax purposes was \$1,000,000); see also Rev. Proc. 2008-66, 2008-45 I.R.B. 1107, 1113-14 (providing that in 2009 the inflation-adjusted annual exclusion amount was \$13,000), available at <http://www.irs.gov/pub/irs-irbs/irb08-45.pdf>.

tax-free material inheritance to those closest to him or her.<sup>298</sup> As a result, in the present transfer tax environment, the pressure on family autonomy is substantially less than in the pre-ERTA, pre-EGTRRA era. This implies that there is little or no need for an additional release valve in the form of a categorically targeted, unlimited education and healthcare exclusion such as § 2503(e).<sup>299</sup>

Although the proposal nominally balances the competing norms of equality of opportunity and family autonomy, if the proposal is routinely ignored because of taxpayers' beliefs about its propriety, no *actual* balancing will occur. Taxpayer resistance to the gift taxation of education and healthcare transfers is driven, at least in part, by the reality that society views families not only as social but also as economic units. As described in Part I above, state law requires parents to financially support their minor children.<sup>300</sup> Even in situations where no legal obligation of support exists, society imposes an effective obligation of support. Many of our educational and healthcare institutions require or encourage families to provide for their own members if they can, and the institutions only intervene when family support is inadequate or unavailable. For example, eligibility for the Federal Pell Grant Program, the largest federal college grant program, is means tested. The formula used to determine financial need includes not only the income and assets of the student, but also those of his or her parent(s).<sup>301</sup> In other words, the federal formula requires parents with means to contribute to a child's college expenditures before federal grant aid will become available.<sup>302</sup>

There is seemingly a contradiction between society's "functional" view of the family "as one of the social institutions that help[s] secure economic security for its members"<sup>303</sup> and society's decision to tax the provision of such

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298. See I.R.C. § 2010(c) (providing that in 2009 the estate tax applicable exclusion amount was \$3,500,000); see also *supra* text accompanying note 37.

299. As a practical matter, the necessity of § 2503(e) was also substantially reduced in 1997 by the introduction of a tax-advantaged college savings account option under § 529 of the IRC that allows wealthy donors to prepay college expenses in a federal income and wealth transfer tax efficient manner. See I.R.C. § 529 (2006), amended by American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, § 1005, 123 Stat. 115, 316. See generally Kerry A. Ryan, *Access Assured: Restoring Progressivity in the Tax and Spending Programs for Higher Education*, 38 SETON HALL L. REV. 1, 24-28 (2008).

300. See *supra* note 48 and accompanying text.

301. See Ryan, *supra* note 299, at 15-19 (describing the methodology for determining financial need for purposes of federal college student aid programs).

302. Some would argue that this system implicitly taxes a family's income and wealth. See, e.g., Andrew W. Dick & Aaron S. Edlin, *The Implicit Taxes from College Financial Aid*, 65 J. PUB. ECON. 295 (1997); Martin Feldstein, *College Scholarship Rules and Private Saving*, 85 AM. ECON. REV. 552 (1995).

303. See Alstott, *Family Values*, *supra* note 12, at pt. V, para. 1.



security. In advocating a wealth transfer tax, Franklin D. Roosevelt was well aware of this inherent tension:

The desire to provide security for one's self and one's family is natural and wholesome, but it is adequately served by a reasonable inheritance. Great accumulations of wealth cannot be justified on the basis of personal and family security. In the last analysis such accumulations amount to the perpetuation of great and undesirable concentration of control in a relatively few individuals over the employment and welfare of many, many others.<sup>304</sup>

This contradiction disappears, however, when one recognizes that the generous gift tax exemptions in the form of the annual exclusion and the unified credit allow for satisfaction of these familial support obligations in a gift-tax efficient manner. As Anne Alstott argues, "high exemption levels fail to resolve the functional-family objection to inheritance taxation *only if* the ideal of the functional family insists that 100% of family wealth should be available to meet family members' . . . needs."<sup>305</sup>

Furthermore, transfers that discharge a legally imposed support obligation will remain gift tax-free under the proposal.<sup>306</sup> This in and of itself is a significant concession favoring family autonomy over equality of opportunity. Human capital transfers that benefit minor children are probably more problematic from an equality of opportunity standpoint than those same transfers to adult beneficiaries. Superior access to medical and educational institutions during the early years of development tends to favorably affect an individual's lifetime opportunity set more than education or healthcare received much later in life.<sup>307</sup> Generally, the opportunity to use the provided resources to affect life chances declines over a person's lifetime.<sup>308</sup>

Despite the general propriety of including human capital transfers in the gift tax base and forcing a donor to use his or her general gift tax exemptions to shelter such transfers, there are two prototypical situations that still require redress. The first is the situation where an adult child with no remaining unified credit pays the medical expenses of an elderly relative in a year in

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304. H.R. REP. NO. 74-1681, at 2 (1935) (reprinting the President's message dated June 19, 1935).

305. Alstott, *Family Values*, supra note 12, at pt. V, para. 8. If the law took seriously the role of the family as economic insurer, it would not only permit tax-free transfers for education and healthcare, but require them beyond the age of majority. *See id.* Furthermore, testator freedom would give way to required distribution of estates according to the needs of various family members. *See id.*

306. *See supra* notes 47-48 and accompanying text.

307. *See* Vandeveld, supra note 234, at 4.

308. *See* Alstott, *Equal Opportunity*, supra note 2, at 473.

which such expenses exceed the annual exclusion. The second is where a grandparent pays a grandchild's primary- and secondary-school expenses under the same conditions.<sup>309</sup> In both cases, the transfers would actually result in a gift tax payable instead of passing gift tax-free under the annual or lifetime exclusion amounts. These scenarios are especially likely to occur given the reduced applicable exclusion amount available to shelter inter vivos transfers (as opposed to transfers at death) under EGTRRA.<sup>310</sup>

Requiring these two prototypical transferors to pay a gift tax would likely cause pushback from taxpayers that could undermine support for general inclusion of human capital transfers in the gift tax base. A small concession to family autonomy is justified on these grounds. Accordingly, the proposal outlined above would provide limited, targeted relief from gift tax liability resulting from the general inclusion of education and healthcare transfers in the gift tax base. This relief would take the form of a tax credit available *after* application of the gift tax unified credit. While this limited exception is largely symbolic, symbolism matters in shaping perceptions, and perceptions matter in shaping beliefs. If taxpayers perceive that Congress is attempting to balance family autonomy against equality of opportunity, their view of the legitimacy of the product of such balancing efforts will be enhanced.

### *VII. Conclusion*

This article addressed the question of whether education and healthcare transfers should be included in the gift tax base. It initially framed the issue in two ways: (1) through the lens of a proposal by the American Law Institute to exempt all "transfers for consumption" from gift taxation, and (2) within the context of a debate among economists about whether such expenditures should be included in the definition of "intergenerational transfers" for purposes of determining the total share of such transfers in U.S. accumulated wealth. Finding the first lens unsatisfactory on its own doctrinal terms and the second lens inconclusive, the article shifted the focus of analysis to the normative first principles implicated by this inquiry, namely, equality of opportunity and family autonomy.

The main claim of this article is that the exclusion of education and healthcare transfers from the gift tax base is indefensible under an equal

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309. Primary- and secondary-school expenses do not qualify for favorable treatment under § 529, *see supra* note 299, because such schools are not "eligible educational institutions." *See* I.R.C. § 529 (e)(5) (2006); Prop. Treas. Reg. § 1.529-1(c), 63 Fed. Reg. 45019, 45026 (Aug. 21, 1998). Furthermore, transfers from a grandparent to a grandchild are generally subject to gift taxation because they are not made pursuant to a legal obligation of support.

310. *See* I.R.C. §§ 2010(c), 2505 (2006); *see also supra* text accompanying note 37.

opportunity framework, but that outright repeal of the exclusion is neither desirable (because of the competing value of family autonomy) nor politically possible. Accordingly, this article proposes an alternative to the current unlimited gift tax exclusion for tuition and medical care payments that appropriately balances these competing norms in a politically feasible manner: Congress should convert the existing gift tax exclusion into a tax credit available *after* application of the gift tax unified credit.