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Reforming the Kiddie Tax

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ABSTRACT

In 1986, concerned that wealthy parents were sheltering some of their income from taxes by giving some portion of their securities portfolios to their children, Congress enacted the "kiddie tax," which taxes a child's passive income at the child's parents' tax rate. By doing so, Congress intended to reduce tax-motivated income-shifting. Since its passage, however, there has been little serious consideration of whether the kiddie tax successfully prevents the targeted income-shifting.

This Article reexamines the kiddie tax and concludes that it is both over- and underbroad. The kiddie tax subjects all of a child's passive income, not just income resulting from tax-motivated income-shifting, to her parents' higher tax rates. At the same time, the kiddie tax does nothing to prevent large categories of income-shifting, including the transfer of income-producing property to adults and the transfer of appreciated property to children or adults. Moreover, taxing a child's passive income at her parents' rate does not reflect economic reality; children and their parents do not necessarily comprise an economic unit. The distortions caused by the kiddie tax are not benign, moreover: as a result of the inefficiency of the kiddie tax, children are discouraged from saving and investing their money.

The Article concludes that the reason for the kiddie tax's over- and underbreadth is that tax-motivated income-shifting is not primarily the result of the relationship between parents and children. Instead, it is the result of the income tax treatment of gifts. In order to more efficiently prevent tax-motivated income-shifting without discouraging children from investing and saving their money, Congress should repeal the kiddie tax and, instead, treat the giving of a gift as a taxable realization event to the donor and require a donee to include the receipt of a gift in gross income.

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INTRODUCTION

In part motivated by concerns that some corporations and high-income individuals were paying little or no tax as a result of tax-avoidance strategies then available to them, including income-shifting,[1] Congress enacted the Tax Reform Act of 1986.[2] One of

[1] For purposes of this Article, "income-shifting" refers to the practice of a high-income taxpayer giving assets to a lower-income taxpayer so that either income produced by the asset or capital gains on the sale of the asset will be taxed at a lower rate.

[2] Pub. L. No. 99-514, 100 Stat. 2085 (1986). *See* Alan J. Auerbach & Joel Slemrod, *The Economic Effects of the Tax Reform Act of 1986*, 35 J. ECON. LITERATURE 589, 598 (1997) ("The reform included a number of pro- visions designed to prevent

Congress's targets was wealthy parents who were unfairly reducing their tax bills by giving some of their dividend-paying stocks and interest-bearing bonds to their children;[3] in order to stop this tax-motivated income-shifting, Congress enacted the "kiddie tax."[4]

Prior to the enactment of the kiddie tax, by giving their children income-producing securities, parents could cause dividends and interest to be earned by the children and therefore to be taxable at the children's lower tax rates instead of the parents' higher rates. Congress was suspicious of these gifts. Any income deflected to the children, Congress believed, in essence continued to benefit the parents. It viewed the deflected income either as being still under the indirect control of the parents or, even if it did in fact belong to the children, as reducing expenses that their parents otherwise would have had to bear. In order to combat this abuse, the kiddie tax in essence taxed any passive income earned by a child 14 years old or younger at her parents' marginal tax rate.[5] The kiddie tax succeeded in significantly reducing the advantages of shifting income to children.[6] It was aided by the Tax Reform Act's reduction of the number of tax brackets from fourteen to two, which reduced the amount of tax savings possible as a result of income-shifting.[7]

Not surprisingly, the kiddie tax resulted in nearly immediate backlash and confusion. On a visceral level, it felt unfair. In fact, it

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corporations and higher-income individuals from us- ing certain tax-avoidance strategies to pay little or no tax.").

[3] *See* S. REP. NO. 99-313, at 862 (1986) *as reprinted in* 1986-3 C.B. 1, 862 [hereinafter, Senate Report] ("[T]he committee is aware that the treatment of a child as a separate taxpayer encourages parents whose income would otherwise be taxed at a high marginal rate bracket to transfer income-producing property to a child to ensure that the income is taxed at the child's lower marginal rates.").

[4] Victor Thuronyi, *The Kiddie Tax: A Reply to Professor Schmolka*, 43 TAX L. REV. 589, 589 (1988).

[5] Leo L. Schmolka, *The Kiddie Tax Under the Tax Reform Act of 1986: A Need for Reform While the Ink Is Still Wet*, 11 REV. TAX'N INDIVIDUALS 99, 102 (1987). In 2006, the age at which a child would no longer be subject to the kiddie tax was raised to 18 (or, in the case of a student whose earned income does not exceed half of the amount of her support, 24). *See* Tax Increase Prevention and Reconciliation Act of 2005, Pub. L. No.109-222, § 510(a).

[6] Frederick R. Schneider, *Which Tax Unit for the Federal Income Tax?*, 20 DAYTON L. REV. 93, 105 (1994) ("Thus, only a comparatively small amount of the child's income will be taxed at a rate lower than the parent's rate, significantly reducing the incentive to shift income to a child who is less than fourteen years of age.").

[7] *Id.* at 103.

was easy to find applications of the kiddie tax that seemed to illustrate the concept of injustice perfectly. In 1988, the *Washington Post* carried a story, implicitly outraged, about a 12-year-old boy who received a $200,000 settlement because of severe brain damage. The money was invested and, in 1987, earned $29,000 in interest and dividends. As a result of the kiddie tax, the boy was taxable on the interest and dividends at his parents' rate of 38.5 percent rather than the lower marginal rates at which he would have been taxable had he been an adult or otherwise not subject to the kiddie tax.[8] Intuitively, it seemed unjust to tax a brain-damaged child at his parents' rate on income that was meant to support him, especially because the kiddie tax was meant to prevent abusive tax-motivated behavior. There was nothing abusive or tax-motivated about the boy's receiving a return on his principal with which to pay his expenses. But in spite of its non-abusive nature, the kiddie tax clearly reached his interest and dividends, taxing them at his parents' rate.

In addition to anecdotal injustice,[9] the kiddie tax represented a radical departure from established tax norms. Its enactment represented a partial shift from treating a child as an autonomous economic actor to treating her as part of an economic unit, made up of her and the other members of her family. Although spouses have been able to file joint returns, electing to be treated as a single economic unit for tax purposes, since 1948,[10] up until the passage of the kiddie tax in 1986, children were not treated as part of the unit for tax

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[8] Anne Swardson & Lisa Leff, *Tax Bills Shock Many Washingtonians*, Washington Post, Mar. 20, 1988, at A1. Courts have found that the application of the kiddie tax to interest earned on money received by a child from someone other than the child's parents or grandparents is constitutionally permissible, notwithstanding its falling outside the scope of Congressional intent in enacting the kiddie tax. Carlton v. United States, 789 F. Supp. 746, 748 (N.D. Miss. 1991). Moreover, had the boy received the $200,000 settlement after enactment of the kiddie tax, he would have been taxable at his parents' top marginal rate on the settlement amount.

[9] Professors Auerbach and Slemrod argue that the kiddie tax "received publicity far out of proportion to its revenue impact." Auerbach & Slemrod, *supra* note 2 at 598. While it may be true that the kiddie tax produces a marginal amount of federal revenue, it seems likely that the publicity was a result of the apparent unfairness of the kiddie tax, the anecdotal evidence of which was easy to find.

[10] *See* Surrey, *Federal Taxation of the Family—The Revenue Act of 1948*, 61 HARV. L. REV. 1097, 1106 (1948) ("The plan [to permit income-splitting] revolves entirely around the utilization of a familiar device, the voluntary joint return filed by husband and wife.").

purposes.[11] And even with the long history of allowing spouses to file joint returns, the question of whether spouses should, in fact, be treated as an economic unit remains controversial.[12]

Congress hedged its assertion that a child's income should properly be aggregated with her parents', though: the kiddie tax does not apply to compensation earned by a child. Because of the kiddie tax, then, a child's economic identity is bifurcated. She is an autonomous economic actor with respect to her earned income, but is part an economic unit with her family with respect to her passive and other unearned income.

Since its passage, though, there has been little consideration of the policies underlying the kiddie tax or its effectiveness. An initial colloquy of two articles published shortly after the enactment of the kiddie tax discussed the kiddie tax's purpose and alterations to the original legislation that could be made in order that the kiddie tax would be more effective,[13] and subsequently, the occasional article has discussed the kiddie tax in light of the problem of income-shifting or in order to discuss how to comply with or plan around the higher rates imposed by the kiddie tax.[14] But there has been no discussion of

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[11] *See* Boris I. Bittker, *Federal Income Taxation and the Family*, 27 STAN. L. REV. 1389, 1414 n.68 (1975) ("Indeed, Congress deliberately eschewed the aggregation of children's income with their parents' even where consolidation would have been most appropriate and would almost certainly have encountered no constitutional barrier . . . perhaps because aggregation was deemed politically unacceptable."); *cf.* I.R.C. § 73(a) ("Amounts received in respect of the services of a child shall be included in his gross income and not in the gross income of the parent, even though such amounts are not received by the child.").

[12] *See infra* Section III.

[13] *See generally* Thuronyi, *supra* note 4; Schmolka, *supra* note 5.

[14] *See, e.g.*, Leonard J. Lauricella, *The New Kiddie Tax: Tax Planning with Acceleration and Deferral*, 117 Tax Notes 1235 (2007) (discussing how certain children may generate losses in on year to avoid kiddie tax liability in the subsequent year). That the bulk of articles written on the kiddie tax address how to avoid it or lessen its effects makes it appear that the kiddie tax is ineffective in raising revenue. Rather, it creates waste in the system: children pay money (*e.g.*, for tax and investment advice and administrative costs in structuring their investments) in order to avoid the kiddie tax, instead of using the money as they would prefer to use it. This additional money does not all serve to increase the government's revenue. That portion that is lost to administrative expenses is waste. *See* Samuel D. Brunson, *Elective Taxation of Risk-Based Financial Instruments*, 8 HOUS. BUS. & TAX L.J. 1, 10-11 (2008) ("This economic waste, measured in money and time spent avoiding taxes, could be better spent in socially and economically productive ways.").

whether the kiddie tax successfully prevents the tax-motivated income-shifting Congress was attempting to prevent through its enactment, what unintended consequences result from the kiddie tax, whether the kiddie tax represents good tax policy, or whether there is a more effective way to prevent income-shifting.

As we approach the kiddie tax's twenty-fifth anniversary, this Article intends to begin to remedy the lack of analytical attention it has received. This Article intends to analyze the effectiveness of the kiddie tax in light of Congress's stated objectives in passing it and will analyze whether the kiddie tax represents good tax policy. Finding the kiddie tax wanting in both of these areas, the Article will then propose an alternative regime that will more act as a more effective gate to income-shifting.

In evaluating the kiddie tax's effectiveness and in proposing alternatives, the Article will focus on Congress's original goal of preventing of tax-motivated income-shifting. The goal of the kiddie tax, or any other anti-abuse regime, should be to discourage *tax-motivated* income-shifting, not to prevent all income-shifting. A taxpayer may have a legitimate non-tax reason to transfer income-producing property to another person. If she were entirely prevented from doing so, the anti-abuse regime would introduce distortions that would reduce the efficiency of the tax law. Instead, an anti-abuse regime should counteract such distortions, minimizing a taxpayer's incentive to participate in transactions that are motivated solely by tax considerations, but not transactions that would occur even in a tax-free world.

The kiddie tax is not carefully calibrated to prevent tax-motivated income-shifting. In fact, it casts its net both too widely and too narrowly. It is clear that the kiddie tax is overbroad. For example, the investment return on a child's personal injury recovery was not the type of abusive behavior the kiddie tax was intended to rectify. Because the kiddie tax applies to all of a child's passive income, and not only to income-shifting gifts to children, the kiddie tax discourages children from participating in certain transactions that are neither tax-motivated nor abusive.

Less intuitively obvious, but no less clearly, the kiddie tax is underinclusive. In order to become subject to the kiddie tax, a child's passive income must exceed a threshold amount.[15] To the extent that a parent deflects less than the annual threshold amount to her child, the parent is still capable of shifting income. Moreover, to the extent that the parent can transfer assets to her child on which the income will be deferred until after the child is no longer subject to the kiddie tax, the parent's higher marginal tax rates will not apply. In fact, a highly-taxed person can shift income to any adult taxed at a lower rate—including her adult child, her partner, or, in some cases, her spouse—while maintaining control over the asset. Even if the donee pays the donor's living expenses with the transferred income, that income will not be taxed at the donor's higher tax rate.

By being both overbroad and underinclusive, the kiddie tax introduces significant distortions into the saving and investment strategies of children. In order to avoid the potentially sharply-steeper rates applicable to a child's passive income, financial advisors recommend, among other things, that children invest in mutual funds that focus on growth securities rather than investments that pay current income, and wait to sell the mutual funds until after the kiddie tax no longer applies and other assets that defer taxable payments.[16] Alternatively, financial advisors recommended the children's money be invested in mutual funds that would not pay dividends that were more than the exemption amount during a year.[17]

The Article will proceed as follows: Section I will briefly review the history and mechanics of the kiddie tax. Section II will discuss the place of efficiency as a hallmark of a good tax system. In addition, it will look at the interrelation between the distortions that lead to income-shifting and the distortions introduced by the kiddie tax. Section III will then summarize major arguments for and against aggregating individuals into larger economic units for tax purposes.

Section IV discusses in detail the distortionary effects of the kiddie tax's overbreadth on children's investment and savings decisions. Section IV also discusses other avenues of income-shifting that are actually *encouraged* as a result of the underinclusiveness of

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[15] I.R.C. § 1(g)(4). For 2010, that threshold amount is at least $1,900. Rev. Proc. 2009-50 § 3.02, 2009-45 I.R.B. 1.

[16] *See* Julian Block, *Timing of Stock, Bond Sales Can Reduce Kiddie Tax*, St. Louis Post-Dispatch (Missouri), Sep. 4, 1989, at 12.

[17] *See* Elizabeth Christian, *Investment Outlook; Beyond the Traditional; How to Afford a Private School Education; Saving, Planning Early Can Help Ease High Costs*, L.A. Times, Dec. 3, 1989, at R18.

the kiddie tax.. Finally, Section V proposes that the kiddie tax be replaced by two significant changes to the income tax treatment of gifts: (1) the giving a gift of appreciated property should be a tax realization event for the donor and (2) the value of the gift should not be excluded from a donee's gross income. Enacting these two changes to the income tax treatment of gifts would eliminate the distortions introduced by the kiddie tax while also counteracting the distortions that make tax-motivated income-shifting work as a tax-reduction strategy. As such, replacing the kiddie tax with these changes would limit tax-motivated income-shifting more effectively than the kiddie tax has.

I. THE KIDDIE TAX

Under the U.S. tax system, income derived from property is almost always taxed to the owner of the property.[18] When income from property is taxed to somebody other than the owner of the property, it is generally because Congress or a court has stepped in to prevent what it views as income-shifting where the incidence of the tax does not match the economic beneficiary of the income. That is, the default rule taxing income from property to the owner of the property generally applies unless the court, the IRS, or Congress feels that taxpayers are engaging in abusive transactions in order to shift their tax burdens to somebody who will be taxed on the income at a lower rate.

Even when Congress believes there is abuse, however, it does not always change the taxpayer liable for the tax. The kiddie tax is a prime example: Congress was concerned that parents and grandparents were avoiding tax by transferring income-producing assets to their minor children or grandchildren. Because the children are generally taxed at a lower marginal rate than adults, the income would be taxable at the child's lower rate rather than the adult's higher rate.[19] Inasmuch as the adult transferor arguably continues to maintain

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[18] *See* Shmolka, *supra* note 5, at 99-100; *see also* Jonathan G. Blattmachr, *Child's Income May Be Taxed at Parent's Tax Rate*, 66 J. TAX'N 48, 48 (1987) ("Generally, before 1987, unless a special rule applied, each taxpayer was taxed on his or her own income . . . starting with the lowest effective rate in effect for that taxpayer.").

[19] *See* Schmolka, *supra* note 5, at 100.

control over the asset because of her influence over her child,[20] transferring income-producing assets to one's child would seem an ideal way for a high-income taxpayer to reduce her tax liability.

Rather than taxing parents on the passive income generated by transferred property, though, the kiddie tax generally treats the child as the appropriate taxpayer. Instead, the kiddie tax changes the rate applicable to a child's passive income.[21] Although administratively complicated, the rough result of the kiddie tax is to tax children at their parents' highest marginal tax rate on all of their unearned income.[22]

In its originally-proposed form, the kiddie tax would have only applied to a child's unearned income attributable to property transferred to her by her parent or stepparent.[23] The Conference Committee broadened the kiddie tax, however, so that it applied to virtually all unearned income received by a child, whatever the source of the property from which the child receives the income.[24]

Although there have been several minor revisions of the kiddie tax in the years since 1986,[25] the outline remains the same. In its current form, the kiddie tax governs a child's tax liability if, at the end of the taxable year, she is younger than 18 (or, in some circumstances,

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[20] *See* Thuronyi, *supra* note 4, at 590 ("Even if the property is transferred to the children on paper, in reality, the parents may still retain dominion over the property that they enjoyed when it was nominally in their names.").

[21] I.R.C. § 1(g)(1).

[22] Blattmachr, *supra* note 18, at 48.

[23] *See* Senate Report, *supra* note 3, at 862 ("In order to reduce the opportunities for tax avoidance through intra-family transfers of income producing property, the committee concluded that it is generally appropriate to tax the income on property transferred from a parent to a minor child at the parent's marginal rates.").

[24] Blattmachr, *supra* note 18, at 48 ("[T]he Conference Committee elected to have virtually *all* unearned income taxed to the child at the parents' marginal rates of taxation.").

[25] For example, the kiddie tax originally applied only to the unearned income of children under the age of 14; for years beginning after 2005, the kiddie tax was expanded to apply to the unearned income of all children under the age of 18 or 24. Tax Increase Prevention and Reconciliation Act of 2005, P.L. 109-222 § 510(a). Interestingly enough, when originally enacted, Congress chose not to apply the kiddie tax to children over the age of 14 because it assumed that a significant number of children over 14 might have enough earned and unearned income to make the operation of the kiddie tax complicated. *See* Thuronyi, *supra* note 4, at 599 ("[T]he assumption was made that a number of children above age 14 might have substantial earned income and accordingly would have substantially more complicated financial situations than, say, the typical three-year-old.").

24) years old,[26] at least one of her parents is still alive, and she does not file a joint return for the year.[27]

If the kiddie tax applies to a child, she must determine her tax liability under two parallel regimes: she must calculate both the amount of tax she would owe if she were not subject to the kiddie tax and the amount she would owe applying the kiddie tax. She then must pay the higher of the two amounts.[28]

In order to determine what she owes under the kiddie tax, a child must determine her "net unearned income," which is the amount of her adjusted gross income that exceeds her wages, salaries, professional fees, and other compensation.[29] Her net unearned income is further reduced by an inflation-adjusted threshold amount.[30] All passive income—including interest, dividends, and capital gains—is included in net unearned income. Gifts, however, are excluded from the definition of gross income, and would thus not be subject to the kiddie tax.[31]

After determining her net unearned income, a child must calculate her taxable income both applying and ignoring the kiddie tax. In order to calculate her tax liability in the absence of the kiddie tax, a child determines the amount of tax an individual would pay on her taxable income[32] Then, in order to calculate her tax liability under the kiddie tax, she must subtract her net unearned income from her taxable income. Under the kiddie tax, she is taxable at her own

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[26] I.R.C. § 1(g)(2)(A)(i). The kiddie tax applies to taxpayers up to the age of 24 if they are students and their earned income for the year constitutes half of their support or less. I.R.C. § 1(g)(2)(A)(ii).

[27] I.R.C. § 1(g)(2).

[28] I.R.C. § 1(g)(1). Although most children subject to the kiddie tax will be taxable on unearned income at their parents' rate, certain high-earning children may owe more at their own top marginal rate than that of their parents. For example, in 2007, at age 17, Dakota Fanning earned an estimated $4 million. *See* http://www.forbes.com/lists/2007/53/07celebrities_Dakota-Fanning_7WGP.html. Provided her parents were not in the top marginal tax bracket, Ms. Fanning could actually *reduce* her tax liability by applying her parents' rate to her unearned income.

[29] *See* I.R.C. §§ 1(g)(4), 911(d)(2).

[30] I.R.C. § 1(g)(4)(A)(ii). For 2010, that amount is the greater of $1,900 or, if the child itemizes, the sum of $950 plus the itemized deductions directly related to her net unearned income. Rev. Proc. 2009-50 § 3.02.

[31] I.R.C. § 102(a).

[32] I.R.C. § 1(g)(1)(A).

marginal rate on any wage, salary, professional fee, and other compensation income.[33] But she is taxable at her parents' top marginal rate on all of her net unearned income.[34] Her tax liability is the higher of her ordinary tax liability or her tax liability under the kiddie tax.[35]

The kiddie tax significantly increases the complexity of the tax code.[36] Because of the requirements of the kiddie tax, if a child receives unearned income during a year, she must calculate both her ordinary tax liability and her kiddie tax liability; the administrative expense and complexity are a direct result of her receiving passive income (including interest on savings accounts and dividends and capital gains from investments). In addition, in order to comply with her filing requirements under the Code, the parent of any child subject to the kiddie tax must give her taxpayer identification number to her child, and her child must include the taxpayer identification number on her own tax return.[37]

Recognizing the administrative complexity of applying the kiddie tax, the Code allows a parent to elect to include her child's gross income on her own. The benefits of this election are severely constrained, though. It is permissible, though, only if the child's income for the year consists solely of interest and dividends.[38] In general, if a child has any passive income during any taxable year, she will be subject to the administrative costs and burdens of the kiddie tax.

II. EFFICIENCY CONSIDERATIONS

One important hallmark of a good tax system is efficiency. That is, a good tax system avoids interfering with taxpayers' economic

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[33] I.R.C. § 1(g)(1)(B)(i).
[34] I.R.C. § 1(g)(1)(B)(ii).
[35] I.R.C. § 1(g)(1).
[36] Deborah H. Schenk, *Simplification for Individual Taxpayers: Problems and Proposals*, 45 TAX L. REV. 121, 150 (1989).
[37] I.R.C. § 1(g)(6). Besides the administrative obligations, requiring parents to provide their social security numbers to their children potentially raises privacy concerns. *See, e.g.*, Edward J. Eberle, *The Right To Information Self-Determination*, 2001 UTAH L. REV. 965, 971 (2001) ("A person may rightly be concerned over the confidentiality of her SSN and its proper use.").
[38] I.R.C. § 1(g)(7).

decision-making insofar as it is able.[39] To the extent that tax considerations change what a taxpayer would have done in a tax-free world, a tax system creates waste by causing the taxpayer to expend money on planning and compliance and by preventing the taxpayer from allocating her economic resources in the most productive manner.[40]

Distortions are inherent in an income tax. The mere imposition of an income tax will, for example, cause a taxpayer to spend money on compliance and other administrative costs related to determining and paying the tax even though, absent the tax, she would not have incurred those administrative costs.[41] Moreover, the existence of an income tax encourages taxpayers to choose leisure rather than work and consumption rather than saving, even if, absent tax considerations, they would rather work and save.[42] The very abuse the kiddie tax was implemented to prevent—the transfer of income-producing assets from a higher-taxed parent to a lower-tax child—is the result of distortions caused by our progressive income tax system. If there were no difference between the rate of tax paid by the parent and the rate of tax paid by the child, a parent would have only transfer income-producing assets to her child if the parent had a non-tax reason to

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[39] Yoram Margalioth, *The Case for Tax Indexation of Debt*, 15 AM. J. TAX POL'Y 205, 254 (1998) ("The standards for a good tax system are its efficiency and its fairness. By the term efficiency we generally mean minimal interference with economic behavior to allow the allocation of economic resources to their most productive uses.").

[40] Richard A. Epstein, *Taxation in a Lockean World*, *in* PHILOSOPHY AND LAW 49, 56 (Jules Coleman & Ellen Frankel Paul eds., 1987) ("A sound tax . . . will always be subject to some evasive response by private parties. But these are minimized by a system that does not seek to reshape basic preferences . . . .").

[41] *Id.* ("Any tax system costs money to administer . . . . The smaller their sum, the greater the fraction of the social product that is left for use in either public or private hands. . . . If the costs of collection are high, it increases the likelihood that the taxation . . . will not meet the requirements of a proper Pareto-superior forced exchange.").

[42] Margalioth, *supra* note 39, at 254-55 ("The imposition of tax will always have some distorting effects, such as the allocation of resources to administrative costs of complying and collecting the tax, the encouragement of leisure over work and consumption over saving, but a good tax system will keep these distortions minimal.").

prefer that the assets be held by her child.[43] Taxes would not create a financial impetus for her to do so.

By taxing a child's passive income at her parents' rate, the kiddie tax intended to counteract the distortions inherent in a progressive tax by eliminating the tax advantage of giving income-producing property to a child. However, the kiddie tax is a blunt instrument by which to solve the distortions that encourage income-shifting. Raising the rate of tax on a child's passive income eliminates the tax motivation to give a child income-producing property. But it produces distortions in the opposite direction: by imposing a higher tax *and* administrative expenses to comply with its rules, the kiddie tax discourages *any* transfer of income-producing property, not just transfers that are tax-motivated. That is, it treats a transfer from a parent, who may maintain indirect control over the assets, even when putatively owned by her child, and would therefore benefit from the imposition of a lower rate of tax on the asset,[44] the same as it treats the transfer of property from a family friend, who maintains no continuing control over the asset and receives no benefit from its being taxed at a lower marginal rate.[45]

Such an overcorrection, though inefficient, is understandable. After all, any tax provision can create distortions, and it may be difficult to calibrate reform so that it neither over- nor undercorrects the targeted distortion.[46] But the kiddie tax does not merely overcorrect a distortion. Rather, it introduces a new and unrelated

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[43] *See* Henry J. Lischer, Jr., *Incomplete Transfer Tax Repeal: Should the Gift Tax Survive?*, 56 SMU L. REV. 601, 619 (2003) ("As a preliminary matter, it should be noted that income shifting of built-in gain is worthwhile only if the transfer causes the income or gain to be taxed a lesser effective rate of tax than it would in the hands of the transferor.").

[44] Note that, although it is possible that a parent will maintain control over an asset even after transferring it to her child, it is not always the case that she will maintain such control. *See infra* notes 74-83 and accompanying text.

[45] That the family friend gets no benefit from her asset's being taxed at a lower rate is not entirely true in every circumstance: if the family friend were a tax protestor who felt warm and fuzzy when she kept money from getting into the hands of the government, she would benefit from transferring the property. But this type of warm fuzzy feeling is similar to the benefit that somebody gets in general from giving a gift; it is difficult to quantify economically, and for that reason, gift-givers are not taxed on the benefit they get from giving a gift.

[46] *See* Epstein, *supra* note 40, at 56 ("Taxes can create distortions that reduce wealth. The question is how to minimize these distortions.").

distortion: it discourages saving and investment by the child.[47] Any income tax encourages consumption over saving and investment to some extent, by lowering the rate of return on saved and invested money in relation to what it would have been in a world without tax.[48] This broad discouragement of saving and investment by children is unrelated to the transfer of income-producing assets to children. It applies whether the passive income is paid by an asset that was given to the child—either by a parent or anyone else—or whether the child invested her own wage income. Moreover, it does not just apply to risky or unusual investment practices. The kiddie tax is imposed on interest earned by a child on a plain-vanilla savings account at any commercial bank.[49] And now that the kiddie tax potentially applies to people up to the age of 24,[50] its additional distortions are likely to reach income well beyond the scope of the kiddie tax's original mandate.

III. THE FAMILY AS AN ECONOMIC UNIT

Although the kiddie tax was enacted principally to prevent abusive behavior, commentators have advanced policy considerations that, they assert, justify its effective aggregation of a child's income with her parents' in determining the applicable tax rate. The principal policy justification presented for taxing a child's passive income at her parents' rate is that the family is an economic unit and should be treated as such for tax purposes.[51] Such aggregation, while uncommon, is not entirely novel to the tax law and there is an extensive literature debating whether the tax law should aggregate spousal income, effectively treating spouses as a single economic unit,

[47] *See infra* Section IV.A.
[48] Margalioth, *supra* note 39, at 254.
[49] *See* I.R.C. §§ 1(g)(4), 911(d)(2). Because unearned income includes all of a child's income except wages, salaries, professional fees, and other amounts received as compensation for services performed, even income as innocuous as the interest on a savings account is potentially subject to tax at the parents' higher rate.
[50] I.R.C. § 1(g)(A)(ii)(I).
[51] Thuronyi, *supra* note 4, at 599 ("As a matter of principle, there is a strong argument in favor of determining the rate of tax on income of family members by aggregating the family income and making an adjustment for family size . . . .").

or whether spouses should be taxed separately on their individual income.[52]

In debating whether the family should be taxed as an economic unit, commentators and policymakers are in essence trying to determine whether a family's taxpaying ability is better determined "by total family income regardless of the distribution of such income among the members of the family" or by "the separate taxpaying abilities of its individual members . . . [as] determined by the amount of income of which he or she is the owner without reference to the income of other members of the family."[53] If family members pool their resources, it makes sense to treat a family as a taxpaying unit; if, however, they do not pool their resources, the economic argument for treating family members as a single taxpaying entity is far weaker.[54]

Ultimately, the reason aggregation may cause a family's net tax liability to differ from what the family members' tax liability would be if each paid taxes separately is because of the tax law's progressive rate schedule. With a truly flat rate structure, the family members would pay the same net tax, whether they were taxed as individuals or as an economic unit.[55] With a progressive tax, though,

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[52] *See. e.g.*, Stephanie Hoffer, *Adopting the Family Taxable Unit*, 76 U. CIN. L. REV. 55 (2007); Henry E. Smith, *Intermediate Filing in Household Taxation*, 72 S. CAL. L. REV. 145 (1998); Anne L. Alstott, *Tax Policy and Feminism: Competing Goals and institutional Choices*, 96 COLUM. L. REV. 2001 (1996); Nancy C. Staudt, *Taxing Housework*, 84 GEO. L.J. 1571 (1996); Lawrence Zelenak, *Marriage and the Income Tax*, 67 S. CAL. L. REV. 339 (1994); Marjorie E. Kornhauser, *Love, Money, and the IRS: Family, Income-Sharing, and the Joint Income Tax Return*, 45 HASTINGS L.J. 63 (1993); Edward J. McCaffery, *Taxation and the Family: A Fresh Look At Behavioral Gender Biases in the Code*, 40 UCLA L. REV. 983 (1992); Bittker, *supra* note 11.

[53] Bittker, *supra* note 11, at 1392.

[54] Neoclassical economics treated the family as an individual, albeit one whose preferences were a "black box." Robert A. Pollak, *Gary Becker's Contributions to Family and Household Economics*, 1 Rev. Econ. Household 111, 122-23 (2003). Gary Becker introduced a model of family collective choice, an "altruist model" that posits, among other things, resource pooling in families. *Id.* at 131. Subsequent empirical research, however, suggests that families do not simply pool their resources and allocate the pool to maximize a single, familial objective; rather, the person who earns the money maintains some level of control over the use to which that money is put. *Id.* at 131-33; *see also infra* notes 66-71 and accompanying text.

[55] Susan Pace Hamill, *An Argument for Tax Reform Based on Judeo-Christian Ethics*, 54 ALA. L. REV. 1, 47 (2002) ("A flat or proportional income tax structure imposes the same percentage of tax on each taxpayer regardless of income level.").

aggregating a lower-earning family member's (often called the "marginal earner"[56]) income essentially stacks her income on top of the higher-earning family member's income. As a result, "[t]he secondary earner's first dollar of income is effectively taxed at the primary earner's highest or 'marginal' rate."[57] The marginal earner thus loses the benefit of having some portion of her income absorbed by the lower marginal rates.[58]

Marriage throws a wrench into the design of a tax system. At first glance, marriage seems to be a quintessential economic unit, with both spouses jointly controlling marital assets. But on closer examination, there is nothing inherent to marriage that requires couples to behave as an economic partnership. In fact, income-shifting between married couples is possible and has occurred virtually since the first modern U.S. tax law was passed.[59] Ultimately, with the introduction of the joint return, Congress blessed income-shifting between spouses.[60]

But the joint return does not solve all of the problems that marriage introduces into the tax system. Ultimately, it is impossible to achieve progressivity, marriage neutrality, and couples neutrality.[61] Under current law, married couples are generally treated as an economic unit. As an economic unit, a married couple files one tax return showing their aggregate taxable income and they jointly pay tax on that amount.[62] Because on spouse's income is in effect stacked on

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[56] McCaffery, *supra* note 52, at 993.
[57] Grace Blumberg, *Sexism in the Code: A Comparative Study of Income Taxation of Working Wives and Mothers*, 21 BUFF. L. REV. 49, 52 (1971).
[58] Staudt, *supra* note 52, at 1609-10.
[59] *See, e.g.*, Lucas v. Earl, 281 U.S. 111 (1930).
[60] Staudt, *supra* note 52, at 1607 ("Pursuant to the joint return provisions adopted in 1948, spouses may aggregate their income and pay tax as a single unit according to the tax rate schedule for married couples filing jointly.").
[61] "Progressivity means it matters how income is assigned among taxable units; marriage neutrality means marriage does not affect that assignment; and couples neutrality means marriage does not affect the assignment." Zelenak, *supra* note 52, at 342.
[62] Married couples are not *required* to file a joint return and, thus, to be treated as a single economic unit. Staudt, *supra* note 52, at 1607. However, the tax brackets for a married individual filing separately are narrower than the brackets for unmarried individuals or for married individuals filing jointly. *See* I.R.C. 1(a), (c), (d); Rev. Proc. 209-50 § 3.01. Everything else being equal, then, a married person is likely to file a joint return.

top of the others, that spouse loses the advantages of lower marginal rates applying to her income. In order to ameliorate slightly the negative effects of stacking, there are separate tax rate schedules for married and unmarried persons, and the tax brackets for married people are wider than those for single people, though not twice as wide.[63] Wider tax brackets permit a married couple to collectively earn more money than a single person before the couple progresses to the next tax bracket. However, because the tax brackets for married couples are not twice as wide, a married couple can earn less collective income than two single persons would be able to earn before the couple is subject to the next higher marginal tax rate.[64]

Historically, commentators and policy-makers took for granted that spouses acted as an economic unit. In spite of the long history of the U.S. tax law permitting a married couple to aggregate income, recent scholarship disputes the conclusion that spouses *should* be treated as an economic unit. [65] By stacking income, the joint return discourages the marginal earner (often the wife) from working by effectively taxing her first dollar of earnings at a relatively high marginal rate.[66] Moreover, although marriage confers to one spouse certain property rights in the other spouse's property unavailable to non-spouses,[67] it is not always the case that married couples share

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[63] Zelenak, *supra* note 52, at 340 ("[A] joint-return system could be designed with marriage bonuses in some situations and marriage penalties in others. This could be accomplished by a joint-return rate schedule whose brackets are wider than the brackets for single taxpayers, but less than twice as wide. The current law takes this approach.").

[64] *Id.*

[65] *See, e.g.*, Blumberg, *supra* note 57, at 52 ("Aggregation of spousal income, as opposed to individual taxation of each spouse's income, is based on the indisputable economic unity of the family."). Even as she acknowledged that she viewed families as having an economic unity, Professor Blumberg viewed the family as possessing an economic unity, she nonetheless did not believe that spouses should aggregate their income for tax purposes. *Id.* at 95 ("The aggregation of spousal income should be abandoned in favor of individual taxation for all wage earners . . . .").

[66] *See* Alstott, *supra* note 52, at 2009 ("Although the joint return applies a formally gender-neutral tax rate schedule to a couple's aggregate income, wives are often viewed as 'secondary' workers, because they typically earn less than husbands and their jobs often are perceived as more dispensable.").

[67] *See* Cass R. Sunstein, *The Right to Marry*, 26 CARDOZO L. REV. 2081, 2091 (2005) ("Under both state and federal law, spouses may have automatic ownership rights that non-spouses lack. In community property states, people have automatic rights to the holdings of their spouses, and they cannot contract around the legal

control over the family income in practice—there is strong empirical evidence that married couples do not pool all of their resources but, rather, income is often controlled by the earner spouse.[68] Because in many cases spouses do not act as an economic unit, and because treating them as a unit can often have detrimental effects on the spouses individually and on their household finances,[69] some tax scholars have suggested that the tax law should move away from treating even spouses as an economic unit.[70]

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rules. Even in states that do not follow community property rules, states may presume joint ownership of property acquired after marriage and before legal separation.").

[68] Kornhauser, *supra* note 52, at 91 ("The evidence from empirical studies indicates that neither assertions of pooling nor nominal arrangement of assets in a pooling manner accurately reflect the reality of financial arrangements."); *see also* Shelly J. Lundberg, Robert A. Pollak, & Terence J. Wales, *Do Husbands and Wives Pool Their Resources? Evidence from the United Kingdom Child Benefit*, 32 J. HUM. RESOURCES 463, 479 (1997) ("Holding constant total family income, the income received by each spouse has substantial and significant effects on family expenditure patterns."); Martin Browning, Francois Bourguignon, Pierre-Andre Chiappori, & Valerie Lechene, *Income and Outcomes: A Structural Model of Intrahousehold Allocation*, 102 J. POL. ECON. 1067, 1090 (1994) ("[T]he influence of differential incomes and wealth on intrahousehold allocation can be fairly substantial."). It is important to keep in mind that the fact "that spouses do not pool *all* their resources does not mean that they do not pool *any* resources." Jens Bonke & Hans Uldall-Poulsen, *Why Do Families Actually Pool Their Income? Evidence from Denmark*, 5 REV. ECON. HOUSEHOLD 113, 114 (2007).

[69] Kornhauser, *supra* note 52, at 64 ("By 'penalizing' the second worker, the joint return discourages married couples from having a second earner (usually the wife), putting both psychological and economic stress on these families, on the wife in particular.").

[70] *See, e.g.*, *id.* at 108 ("The joint return ought to be abolished. A system that treats each person as a separate taxable unit is more equitable, more consistent with basic tax principles, more efficient, and ultimately better able to accomplish social family goals."); Smith, *supra* note 52, at 151 ("In this Article, I will explore a third alternative, which I call 'intermediate filing.' Instead of allowing couples to 'split' their income as joint filers or forcing them to file as individuals, intermediate filing presents couples with a choice of individual filing as a default or fractional splitting."). *But see* Hoffer, *supra* note 52, at 79 ("[T]he half-steps already taken by Congress demonstrate its acknowledgment of some level of economic interdependence among family members, and particularly children. . . . By providing scattered benefits, Congress has failed to provide holistic treatment of the family. Adoption of the family as the taxable unit is a clear and simple remedy to that problem."); Alstott, *supra* note 52, at 2080 ("[T]he traditional equal treatment rationale for individual filing is weaker than proponents have conveyed. . . . Although individual filing might be structured to reinforce family law rules giving

Although significant empirical work in the last couple decades has demonstrated that families do not pool all of their resources, the research has generally focused solely on "the effects of the relative earning power of husbands and wives."[71] There has been little study of the effects of children's income on familial expenditures.[72] Nonetheless, if the arguments against treating a married couple as an economic unit are compelling, the argument against treating children as being in an economic unit with their parents would seem to make at least as much sense, in part because the case for aggregating children's income with their parents' income is not founded in tax logic, but in an "observer's perception of social realities."[73] The objections marshaled against aggregating spouses' income and discussed above—including that such aggregation discourages earning and that spouses do not, in fact, act as an economic unit—apply equally to aggregating children's income with that of their parents.

But additional objections also apply in the case of children. Adults opt into treatment as an economic unit, both by getting married and by choosing to file a joint return. If they decided they wanted to be treated as distinct economic units, they could choose not to marry or not to file jointly.[74] Children, on the other hand, cannot opt out of the kiddie tax. If a child is younger than 18 (or, in some circumstances, 24), has unearned income, and has a living parent, the kiddie tax applies.[75]

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wives greater legal control over marital property, the most effective means of doing so would undermine the central goal of individual filing—eliminating the secondary-earner bias.").

[71] Carolyn M. Moehling, *"She Has Suddenly Become Powerful": Youth Employment and Household Decision Making in the Early Twentieth Century*, 65 J. ECON. HIST. 414, 415 (2005).

[72] *Id.*

[73] Bittker *supra* note 11, at 1397.

[74] *See, e.g.*, Sharon Jayson, *Census Reveals More Couples: Direct Question Bumps Up Against Data*, USA TODAY, Jul. 29, 2008, at 6D ("The number of opposite-sex couples who live together has jumped from less than 1 million 30 years ago to 6.4 million in 2007 . . . . Cohabitating couples now make up almost 10% of all opposite-sex U.S. couples, married and unmarried."); I.R.C. § 1(d) (rate schedule for married individuals filing separate returns.").

[75] She could opt out, in theory, by getting married and filing a joint return, but even if this were a desirable result, in most states she could not do so until she was at least 16 years old, meaning that somebody younger than 16 would have no way to opt out.

Although parents have an obligation to support their children,[76] children do not have shared rights in their parents' property in the way that spouses have an interest in the other's property.[77] Still, arguably a child's income reduces the amount that parents have to pay to support the child, effectively freeing the parents' money to be spent in other ways.[78]

Even if a child's income reduces the amount her parents have to pay for her support in some cases, though, it does not follow that it frees her parents' money in every case. Children may spend their money on necessities—food and clothing, for example—for which their parents would otherwise have paid. But it is also possible for children to spend their money on nonessential items that their parents did not have any legal or moral obligation to provide and which their parents would not have otherwise purchased. That is, it represents additional, rather than substituted, consumption.

This intuition may be bolstered by research on the allocation of resources of families with working children in the early twentieth century. In contrast to today, where a child's income belongs to the child, and where there are measures to protect a child's resources even from her parents,[79] in the early twentieth century, a child's earnings

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[76] Marsha Garrison, *An Evaluation of Two Models of Parental Obligation*, 86 CALIF. L. REV. 41, 50 (1998) ("Like his contemporaries, Blackstone held that the 'insuperable degree of affection' between parent and child was a sufficient guarantor of parental support to obviate the need for legal sanctions. . . . A hundred years after Blackstone, American family law recognized a paternal support obligation that was enforceable on behalf of the child, rather than the public, and which applied whether or not the child was in danger of becoming a public charge."); John Stick, *Turning Rawls Into Nozick and Back Again*, 81 NW. U.L. REV. 363, 394 (1987) ("I grant that it is first the duty of the parents to support a child . . . ."); David Beck & Sheldon V. Ekman, *Where Does Support End and Taxable Gift Begin?*, 23 N.Y.U. ANN. INST. ON FED. TAX'N 1181, 1183 (1965) ("It is generally recognized that a parent has the obligation to support minor children, regardless of the amount of property owned by the child.").

[77] *See, e.g.*, Stick, *supra* note 76, at 394 ("The child's right to support is not a property right. Parents have no duty to provide the child with property, only with shelter, food, drink, and clothing.").

[78] Bittker, *supra* note 11, at 1397 ("[A]s the children's income grows, the parents are relieved of pressure to support the children currently and to pass on an inheritance to them.").

[79] *See, e.g.*, Joseph M. Dodge, *Beyond Estate and Gift Tax Reform: Including Gifts and Bequests in Income*, 91 Harv. L. Rev. 1177, 1205 (1978) ("Money and property saved by the minor child is not really available to the family as a whole."). In fact,

were seen as the property of her parents.[80] But in spite of the fact that children's income belonged to their parents, there is evidence that working children lost control of their money as it was pooled with other household resources. Rather, there is "evidence
that the income children brought into the household influenced household decisions. They may not have gained equal footing with their parents in all household decisions, but they had, through their work behavior, the ability to alter the allocation of resources within the household."[81] Although there is no empirical evidence describing the pooling of children's income today, it is likely that children have at least as much ability today, with their full ownership of their income, to alter their families' allocation of resources as children a century ago had.

In addition, a child may save some or all of her money and only spend it after she has moved away.[82] As with the discretionary spending, this post-childhood spending often does not substitute for parental spending. As a matter of fact, even assuming that children are part of an economic unit that also includes their parents, children generally only remain part of an economic unit with their parents for a finite amount of time—presumably, a child will eventually leave home, get a job, and neither contribute materially to nor receive material support from her parents.[83]

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in order to protect child performers' assets from being dissipated by their parents, California requires certain employers of minors to deposit 15 percent of the minor's earnings into a "Coogan trust" account, where it cannot be used until the minor is emancipated or turns 18. *See* Saira Din, *Family Chapter 667: Instituting Proper Trust Funds and Safeguarding the Earnings of Child Performers from Dissipation by Parents, Guardians, and Trustees*, 35 MCGEORGE L. REV. 473, 475 (2004).

[80] Moehling, *supra* note 71, at 416 ("But, whereas today the earnings of working children are viewed as the property of the children, in the past, those earnings were viewed as the property of the parents. Working children turned over most, or all, of their earnings to their parents.").

[81] *Id.* at 436.

[82] Dodge, *supra* note 79, at 1205 ("To the extent that the savings are intended to provide for the time when the minor will form a separate tax unit, it would be unfair to tax these amounts at high marginal rates based on the combined income of the family.").

[83] Thirty states actually have filial responsibility statutes that require adult children to provide care for or support indigent parents, but filial responsibility statutes are rarely enforced. *See* Jennifer M. Collins, Ethan J. Leib, & Dan Markel1, *Punishing Family Status*, 88 B.U.L. REV. 1327, 1349 (2008) ("It bears mention that since the 1970s, the vast majority of state statutes requiring adult children to support their

Admittedly, a large number of marriages end in divorce, which also effectively terminates the prior economic unit between spouses, but the specter of possible divorce does not prevent married couples from being treated as a unit for tax purposes.[84] The economic consequences of divorce, however, are significantly different from the economic consequences of a child's moving out. Upon divorce, the former spouses are required to make an equitable division of property, and one spouse potentially has a continuing financial obligation to the other. This division of property and future income reflects that what was once an economic unit has been divided, and so the economics of the unit have to be divided.[85] In contrast, even parents who have a legal financial obligation toward their children are generally no longer financially obligated to their children when their children reach the age of majority.[86]

The argument that the kiddie tax is intended to treat children as an economic unit with their parents is further, and more forcefully, belied by the fact that the tax law does not otherwise treat them as part of an economic unit. Children are taxed at their own rate on all of

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elderly and indigent parents have been enforced rarely or not at all, especially in the criminal context."). In addition, some states, including Illinois, require one or both parents to pay for the educational expenses of non-minor children. *See, e.g.*, 750 ILL. COMP. STAT. ANN. 5/513 (LexisNexis 2010).

[84] Elizabeth Warren, *The New Economics of the American Family*, 12 Am. Bankr. Inst. L. Rev. 1, 23 (2004) ("Pretty much everyone knows that newlyweds now face a high chance of splitting up (although the risk is slightly less than the 50/50 number that circulates as conventional wisdom).").

[85] Alicia Brokars Kelly, *The Marital Partnership Pretense and Career Assets: The Ascendancy of Self Over the Marital Community*, 81 B.U.L. REV. 59, 69-70 (2001) ("The [marriage-as-partnership] theory provides that spouses are partners who each make a set of meaningful, although perhaps different, contributions to the marital enterprise. . . . Therefore, each spouse is entitled to share in the marital estate because each participated in its acquisition. Under this view, the economic resource is apportioned, not based on need or status, but because it has been earned.").

[86] This is not to say that parents cannot, or do not, continue to support their children after the age of 18. However, parents are not generally required to do so. Elizabeth S. Scott, *The Legal Construction of Adolescence*, 29 HOFSTRA L. REV. 547, 559 (2000) ("The financial support obligation of parents generally ends when children attain the age of majority, as does parents' common law right to their children's earnings."). In some states, however, an adult child can sue for retroactive child support. *See, e.g.* Carnes v. Kemp, 104 Ohio St. 3d 629, 2004-Ohio 7107; Tedford v. Gregory, 1998-NMCA-067, 125 N.M. 206, 959 P.2d 540.

their non-passive income.[87] That is true whether they get jobs on their own merits or because of their parents' connections, and is true whether they work in a fast-food restaurant or in their mother's law firm.

There is no economic justification for treating a child as part of an economic unit with her parents when it comes to her passive income, but treating her as an individual taxable unit when it comes to her non-passive income. Money is fungible; its source does not affect its use. If it is true that a child aggregates her income and expenses with her parents, she does so both with respect to wage income and investment income. This bifurcation demonstrates that the kiddie tax in its current form is not, in fact, supportable on the grounds that children and their parents form an economic unit. Instead, the kiddie tax is purely an anti-abuse rule.

IV. EVALUATING THE EFFECTIVENESS OF THE KIDDIE TAX

A. The Kiddie Tax Reaches Income It Was Not Intended to Reach

In order for the U.S. economy to be healthy, some amount of current consumption is necessary. But a healthy economy must balance current consumption against saving and investing for future consumption.[88] Saving and investing are socially beneficial because they may produce positive externalities, benefiting not only the savers, but society in general.[89] It is not clear exactly what savings rate is optimal for the United States—a savings rate as high as China's, for example, would probably be harmful to our current economy—but

[87] The Code is explicit on this point: even if compensation for a child's services is paid to one of her parents, or to anybody else, rather than the child, the compensation is nonetheless includible in the child's gross income. I.R.C. § 73(a).

[88] The commonly-made argument in favor of savings is that, in the long run, savings leads to greater productivity and technology gains. Implicit, but often unsaid, is a cultural argument: that saving leads to thrift and, as such, is "emblematic of virtue." Edward J. McCaffery, *Tax Policy Under a Hybrid Income-Consumption Tax*, 70 TEX. L. REV. 1145, 1161-62 (1992).

[89] Daniel N. Shaviro, *Reckless Disregard: The Bush Administration's Policy of Cutting Taxes in the Face of an Enormous Fiscal Gap*, 45 B.C.L. Rev. 1285, 1309 (2004) ("Increased national saving, however, is thought by many to benefit people other than the savers themselves—in particular, younger people and future generations, who may benefit if productive use of the savings enables them to live in a more affluent society.").

people generally agree that Americans save too little.[90] As recently as 2006, the U.S. savings rate actually became negative.[91] Even in the midst of the recession of 2009, the U.S. savings rate, at 5 percent, remained half of the savings rate as recently as the 1980s.[92]

By taxing children's passive income at their parents' top marginal rate, the tax system distorts children's incentives as they relate both to investing and to saving.[93] Because children can often defer the tax on investment gains by continuing to hold the investment, the kiddie tax may not discourage them from investing, but it increases the lock-in effect and affects the type of investments children are willing to make. Because the tax system only taxes realized gain, the lock-in effect discourages a taxpayer who holds appreciated property

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[90] Stephen S. Roach, *Save More! Save Less! When It Comes to Saving, the U.S. and China Have Opposite Problems*, FORTUNE ASIA, Mar. 20, 2006, at 26, 26 ("Thrifty Chinese have taken saving to excess, while profligate Americans have spent their way into debt. Neither of these trends is sustainable—they lead to destabilizing economic and political developments for both nations—and a better balance must be struck.").

[91] Edmund L. Andrews, *With Housing in a Slump, Mortgages Rose Anyway*, N.Y. TIMES, Mar. 9, 2007, at C2 ("Analysts said that homeowners continued to stretch their resources last year, when household savings rates dipped into negative territory, below zero, and that many people might be at the limit of how much they could borrow."). The savings rate can be negative when people borrow in order to fund consumption in excess of their net worth. *See* Catherine Rampell, *Optimism as Spending Rises Again*, N.Y. TIMES, Mar. 28, 2009, at B3 ("Those figures show Americans to be much thriftier than they were in recent years, when personal savings rates hovered around zero and even dipped into negative territory as consumers took on more debt.").

[92] Edmund L. Andrews, *Obama Aides See Signs of Recovery but Say It Will Be Slow*, N.Y. TIMES, Aug. 3, 2009, at B1. Throughout 2009, the personal savings rate fluctuated from a low of 3.4 percent in February to a high of 6.4 percent in May, the highest rate since 1993. Ron Lieber, *Americans Are Finally Saving. How Did That Happen?* N.Y. TIMES, Dec. 19, 2009, at B1.

[93] *See* Lawrence H. Summers, *Tax Policy, the Rate of Return, and Savings*, NBER Working Paper No. 995 (1982) ("Both the theoretical analysis and the empirical work demonstrate the strong likelihood that increases in the real after-tax rate of return received by savers would lead to substantial increases in long run capital accumulation."). It is worth noting that the children themselves may not be consciously evaluating whether, in light of their taxes, they should invest or spend. But whether the children, their parents, or their investment advisors are making the investment decision, ultimately, the money belongs to the children and they can control how they save or spend it.

from selling that property.[94] To the extent that the taxpayer instead continues to hold the property, her wealth continues to increase, but she is not liable for taxes. The lock-in effect is perhaps the principal justification for taxing capital gains at a lower rate than that at which wage income is taxed.[95] Currently, taxpayers in the lowest two brackets pay no taxes on their long-term capital gains.[96] Under the kiddie tax, however, a child otherwise subject to no tax on her long-term capital gains would generally pay tax at her parents' rate of 15 percent.[97] Under current law, the lowest marginal tax bracket taxes income at 10 percent.[98] If a child were subject to the lowest marginal rate on her earned income, but were subject to the kiddie tax on her passive income, she would pay taxes at a rate five percentage points higher on her long-term capital gains than she would on her wage income. This significantly exacerbates the lock-in effect, because she can avoid this higher rate of tax by holding onto her investments until after she turns 18 (or, under certain circumstances, 24). In the year that she is no longer subject to the kiddie tax, a child is likely to still be in the lowest bracket and thus will be able to realize her gains at a zero rate.

In addition, the kiddie tax discourages children from investing in dividend-paying securities. Like capital gains, under current law, dividends from most U.S. corporations (called "qualified dividend income") are taxed at a 15 percent rate, and are taxed at a zero percent rate to people in the lowest two tax brackets.[99] However, under the kiddie tax, children in the lowest tax bracket would generally be taxable on their qualified dividend income at a 15 percent rate; again, this is five percentage points more than they pay on their ordinary income.[100] Moreover, to the extent that dividend income is not qualified dividend income (because, for example, it is paid by certain

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[94] Noël B. Cunningham & Deborah H. Schenk, *The Case for a Capital Gains Preference*, 48 TAX L. REV. 319, 344 (1993) ("The lock-in effect describes an investor's reluctance to incur a tax on realization of gains[.]").
[95] *Id.* ("The most serious argument in favor of a capital gains preference is premised on the so-called lock-in effect.").
[96] I.R.C. § 1(h)(1)(B).
[97] I.R.C. § 1(h)(1)(C).
[98] I.R.C. § 1(i)(1).
[99] I.R.C. § 1(h)(11).
[100] *See supra* note 98.

foreign corporations), it would be taxable at ordinary rates—up to 25 percentage points more than the child would pay on wage income![101]

Because she can defer the realization of her investments and ultimately pay no taxes when she does sell the investments, the U.S. government is unlikely to receive significant amounts of additional revenue from the higher tax rate on capital gains imposed by the kiddie tax. Children, however, are subject to a significant detriment: they are encouraged to invest in non-dividend-paying growth stocks, even if, absent tax considerations, they would prefer to invest in dividend-paying stocks. In addition, children are discouraged from selling their stocks before their eighteenth birthday, even in the event of a change in circumstances or investment strategies or if they have an investment horizon that ends until they are no longer subject to the kiddie tax. Finally, the kiddie tax makes it difficult for children to adequately diversify their portfolios. For most investors, mutual funds are the most effective way to invest their money and achieve diversification.[102] But mutual funds buy and sell securities, realizing both long-term and short-term capital gains (and sometimes dividend income) annually, and are required to pass the bulk of their gains and

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[101] These numbers assume that the child is in the lowest tax bracket, and her wage income is taxable at a rate of 10 percent, while her parents are in a higher tax bracket, with a marginal tax rate of up to 35 percent. I.R.C. § 1(i).

[102] *See* Alan R. Palmiter & Ahmed E. Taha, *Star Creation: The Incubation of Mutual Funds*, 62 VAND. L. REV. 1485, 1490 (2009) ("Ownership of mutual funds is widespread. Of the 116 million households in the United States, almost 52.5 million (or 45 percent) own mutual funds, far more than hold individual securities, such as stocks and bonds."); John C. Coates IV, *Reforming the Taxation and Regulation of Mutual Funds: A Comparative Legal and Economic Analysis*, 1 J. Legal Analysis 591, 591 (2009) ("Over the past 50 years, mutual funds have become the primary way middle class Americans invest[.]"); Robert C. Illig, *The Promise of Hedge Fund Governance: How Incentive Compensation can Enhance Institutional Investor Monitoring*, 60 ALA. L. REV. 41, 83-84 (2008) ("[Mutual funds'] primary function is to provide the benefits of diversification to investors with relatively small portfolios."); Allan F. Conwill, *Blight or Blessing? The Wharton School Study of Mutual Funds*, 18 BUS. LAW. 663, 667 (1963) ("An investor of moderate means cannot achieve the diversification provided by most funds by individual investment in selected stocks. Unless he has substantial funds available, he cannot buy each of the one hundred or more securities which are in the portfolio of the typical mutual fund. Thus, the mutual fund provides the modest investor with an easy and convenient vehicle for achieving diversification.")

income through to their shareholders annually. Shareholders are then liable to pay taxes annually on such gains and income.[103]

Even if children are not interested in investing, the kiddie tax emphasizes current consumption by discouraging saving. Interest is taxable at ordinary tax rates. Under the kiddie tax, though, interest (including interest on savings accounts) is taxable at a child's parents' marginal rate. Moreover, the child's interest income is effectively stacked on top of her parents' income.[104] That is, she is taxed from her first taxable dollar at her parents' rate. Although economists disagree on how and to what extent an individual's savings decisions are influenced by the tax rate,[105] economic theory suggests that the decision of whether to save for the future or to spend money currently is influenced, at least in part, by the after-tax rate of return of an investment.[106] Assuming that the child is subject to tax at a 10 percent

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[103] *See* I.R.C. § 852.

[104] *See supra* note 46 and accompanying text.

[105] *See* Martin J. McMahon, Jr., *The Matthew Effect and Federal Taxation*, 45 B.C.L. Rev. 993, 1084-88 (2004) ("The reality is that the motivations for saving and the decision of whether to save or consume are so complex that economic theory cannot deal with them very well."). Essentially, if the substitution effect predominates, an increased after-tax rate of return will cause people to increase their amount of saving relative to consumption, whereas if the income effect predominates, an increased after-tax return may cause people to save less because "a target saver can reduce savings and still have the same accumulated fund in a future year." *Id.* at 1084.

[106] Economic theory suggests, and intuitively it makes sense, that a person's propensity for saving is influence by the after-tax return she can earn. A higher return will increase her savings relative to her consumption. There are empirical studies that support the theory, and studies that appear to contradict it. *See, e.g.*, *id.* at 1084 ("Some economists conclude that personal savings responds significantly to the interest rate. Many other economists conclude that there is little if any response; it is 'small and hard to find.'"); B. Douglas Bernheim & John Karl Scholz, *Private Saving and Public Policy*, *in* 7 TAX POLICY AND THE ECONOMY 73, 94 (James M. Poterba, ed., 1993). The difference between practice in theory may be explained, at least in part, by the complexity of all of the factors that a person, in real life, is forced to consider in making the decision whether to save or consume, including phase-outs of certain benefits and qualification for others. *See* Laurence J. Kotlikoff & David Rapson, *Does It Pay, at the Margin, to Work and Save? Measuring Effective Marginal Taxes on Americans' Labor Supply and Saving*, *in* 21 TAX POLICY AND THE ECONOMY 82, 83 (James M. Poterba, ed., 2007) ("Yet any American seeking to understand her total effective net marginal tax on either choice [*i.e.*, working or saving] faces a daunting challenge. First, she needs to consider a host of taxes and transfers . . . . Second, she needs to understand in very fine detail how each of these taxes and transfers is calculated. Third, she needs to understand

rate, and that her parents are in the highest tax bracket, rather than keeping $9 for every $10 of interest she earns, that is, she will only keep $6.50. The 25 additional percentage points that she has to pay in tax may, at least on the margin, convince her that she is better off spending her money today, even if there is something more expensive in the future that she would rather spend her money on, because of her diminished return on her investment.

The tax law contains a number of provisions that diminish the sting of the kiddie tax. The kiddie tax does not kick in, for example, until after a child has earned a threshold amount of passive income.[107] In addition, the Code provides for a number of tax-advantaged savings accounts. But none of these partial solutions fully offsets the distortions to saving and investment caused by the kiddie tax.

It is true that the brunt of the kiddie tax falls on children of wealthy taxpayers. Still, "While it is possible to argue that any complexity attributable to the kiddie tax should not be of major concern because it applies primarily to wealthy taxpayers who can afford sophisticated tax advice, it seems clear that the rules also impinge on taxpayers who cannot readily afford such advice."[108] Although the kiddie tax provides for a threshold amount of unearned income that will be exempt from its higher rates, the kiddie tax remains overbroad. Assuming the minor can earn an annual return of 5 percent on her savings and investment, all she needs is $38,000 of investable to meet the threshold for 2010.[109] If she manages a 10 percent return, the amount she needs to invest drops to $19,000.[110] While these are significant amounts, it is not impossible for a minor to

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the interactions of the different tax and transfer regimes. Fourth, she needs to consider the fact that these taxes and transfers are paid and received over time. And fifth, she needs to have a method for translating all of these interconnected time-dated tax payments and benefit receipts into a simple and comprehensible statement of her marginal reward for working and saving."). In the case of the kiddie tax, on the other hand, the calculus is fairly simple: given the after-tax rate of return (and the administrative burdens associated with calculating and reporting the kiddie tax), is it preferable for the minor to save her money for consumption in the future or to spend the money now?

[107] I.R.C. § 1(g)(4)(A)(ii). The threshold amount for paying the kiddie tax is indexed to inflation. For 2010, that threshold amount is not less than $1,900. I.R.C. § 1(g)(4)(A)(ii).

[108] Schenk, *supra* note 36, at 150.

[109] $38,000 × 0.05 = $1,900.

[110] $19,000 × 0.05 = $1,900.

earn that much, especially if she has earned money and has received gifts over the course of her life.[111]

It is important to note that the purpose behind the kiddie tax is *not* to cause children to be taxed on gifts they have received; Congress has determined that gifts do not constitute gross income, and has not limited that determination to gifts for adults.[112] The kiddie tax was intended solely as an anti-abuse rule to prevent income-shifting, and cannot be justified on other grounds.[113]

Under current law, minors have avenues by which they can save and invest their money and not pay taxes on the passive income at their parents' (or any other) marginal rate. Most notably, provided she meets the prerequisite requirements, a child can put her money in a tax-advantaged education savings plan, such as a 529 plan, or in an individual retirement account.

A 529 plan is a state-run education savings program.[114] By investing her money through a 529 plan, a child can earn a tax-free return on that money.[115] Moreover, unlike most tax-deferred

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[111] That the kiddie tax may apply until a taxpayer turns 24 makes it even more possible for a taxpayer who is subject to the kiddie tax to earn enough passive income to be required to pay taxes at her parents' rate than when it only applied to a child until she turned 14.

[112] *See* I.R.C. § 102(a).

[113] *See* Blattmachr, *supra* note 18, at 48 ("Now, however, the Tax Reform Act of 1986 presents additional statutory hurdles in an attempt to hinder the shifting of income [including the kiddie tax]."). Professor Thuronyi argued that the kiddie tax could be justified more broadly by an appeal to the Haig-Simons concept of income. But because doing so would require measuring each family members' income and consumption over the course of each year, practical considerations justified aggregating all family members' income. Thuronyi, *supra* note 4, at 591. As has been discussed previously, however, though this argument would have some purchase if the kiddie tax aggregated *all* of a child's income with her parents, however, because the kiddie tax only taxes a child's passive income at her parents' marginal rate, the kiddie tax cannot be justified by an appeal to the child as part of an economic unit with her parents. *See supra* Section III. As the age limit for the kiddie tax has been raised, the kiddie tax has begun to look less like an anti-abuse provision and more like a revenue-raiser.

[114] *See* Mercer E. Bullard, *The Visible Hand In Government-Sponsored Financial Services: Why States Should Not Be Allowed to Offer 529 Plans*, 74 U. CIN. L. REV. 1265, 1267 (2006). In fact, there are two types of 529 plans: one allows for prepaid tuition at in-state colleges and universities, I.R.C. § 529(b)(1)(A)(i), while the other allows for the investment of money on a tax-free basis to meet college expenses. I.R.C. § 529(b)(1)(A)(ii). This Article will only discuss the second type of 529 plan.

[115] I.R.C. § 529(a).

investments, withdrawals from a 529 plan are also free from tax, provided they are used to pay for qualified educational expenses.[116] There is also no limit on the amount that may be contributed to a 529 plan, provided the 529 plan has adequate safeguards to prevent contributions in excess of what will be necessary to meet the child's qualified educational expense.[117]

To the extent that a child has earned income, she can also save and invest her money through an individual retirement account. An individual retirement account allows taxpayers to invest their money without paying taxes on any income earned on the investment until the money is withdrawn.[118] In general, when withdrawn, gain on the individual retirement account is taxed at the taxpayer's own marginal account; however, in general, if money is withdrawn before a taxpayer is 59½ years old, the tax law imposes a 10 percent penalty in addition to the ordinary tax that is due.[119] There are certain exceptions to this penalty, including if the money is withdrawn by a qualified first-time homebuyer[120] or is used to pay certain higher education expenses.[121]

Although these, and certain other, tax-advantaged savings vehicles can be used to allow a child to save money without paying taxes on income earned on that money at her parents' marginal tax rate, the uses to which she can put the money are drastically limited. Essentially, she can save for college, a home, or retirement. While these are all worthy and important goals, a child may have short- or medium-term investment goals other than college, homeownership, and retirement. Children are discouraged from saving for such medium-term goals,[122] however, because they will pay taxes on interest earned on their money at their parents' higher rate of tax.

As a result of the overbreadth of the kiddie tax, children can be required to pay taxes at their parents' higher tax rate, even on income

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116 Bullard, *supra* note 98, at 1268.

117 I.R.C. § 529(b)(6).

118 George Salimbas, *Educational Opportunities for Taxpayers*, 18 AKRON TAX J. 1, 9 (2003).

119 I.R.C. § 72(t)(1).

120 I.R.C. § 72(t)(8).

121 I.R.C. § 71(t)(7).

122 A child's medium-term consumption goals may include purchasing a car, computer, musical instrument, or other good that is expensive enough that she will need to save in order to purchase it, but that she should be able to purchase before she is no longer subject to the kiddie tax.

that does not result from tax-motivated income-shifting. Moreover, the overbreadth of the kiddie tax introduces significant distortions into children's financial planning, encouraging immediate consumption over medium- and long-term savings and investment.

B. The Kiddie Tax Fails to Prevent a Broad Range of Tax-Motivated Income-Shifting

In addition to being overbroad, the kiddie tax is significantly underinclusive in combating the tax-motivated income-shifting it was intended to combat. While true that the kiddie tax makes tax-motivated gifts of income-producing property to children less attractive, it does not address tax-motivated gifts of income-producing property made to adults.

The current administration of the tax law strongly encourages heterosexual married couples to file joint returns.[123] Because joint returns treat a married couple as an economic unit, disregarding which of the two earns any given piece of income, the joint return eliminates any incentive for a high-earning wife to give her low-earning husband income-producing assets because the income will be taxed at their joint rate in any event. No tax savings results from shifting assets between spouses who file a joint return. The same does not hold true, though, for unmarried couples, even if they live together, pool their income, and otherwise function as an economic unit.

> Marriage alone between a man and a woman entitles these taxpayers to special tax treatment regardless of the couple's resources, consumption patterns, or allocation of responsibility for financial management. Under present law taxpayers who are not married (or who cannot marry at least for federal purposes) are not eligible for transfer tax benefits even if they demonstrate that they function as a single economic unit.[124]

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[123] While married couples have the option to file separately, the tax brackets are set so that a married person filing separately is not only disadvantaged in relation to a married person filing jointly, but in relation to an unmarried person. *See, e.g.*, Rev. Proc. 2009-50 § 3.01.

[124] Bridget J. Crawford, *One Flesh, Two Taxpayers: A New Approach to Marriage and Wealth Transfer Taxation*, 6 FLA. TAX REV. 757, 793 (2004).

Even two people who have entered into a state-sanctioned civil union are not "spouses" for purposes of the tax law and, because they are not "spouses," are not eligible to file a joint return. Moreover, a same-sex couple, legally married in a state that recognizes same-sex marriages, is not treated as married for purposes of the tax law.[125]

Because unmarried couples are not eligible to file joint returns, and thus be treated as an economic unit for tax purposes, such couples are capable of engaging in the income-shifting activities that the kiddie tax was meant to quash.[126] If one individual is in a higher tax bracket than the other, the couple can lower its effective tax if the high-earner makes a gift of income-producing property to the low-earner. Provided the couple acts as an economic unit,[127] the donor should effectively maintain the same control over the property she did before, and should receive the same (shared) economic benefit from income

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[125] *See* 1 U.S.C. § 7. Pursuant to the Defense of Marriage Act, for purposes of all federal laws (including the federal income tax), "the word 'marriage' means only a legal union between one man and one woman as husband and wife, and the word 'spouse' refers only to a person of the opposite sex who is a husband or a wife." *Id.*

[126] Theodore P. Seto, *The Unintended Tax Advantages of Gay Marriage*, 65 WASH. & LEE L. REV. 1529, 1563 (2008) ("Gay couples who pool their finances, however, are not subject to the joint return rules or the punitive married-filing-separately rates that effectively force most heterosexual married couples into a joint return posture. They can therefore income-split and, in a progressive rate environment, benefit from doing so.").

[127] There is some debate over whether married couples in fact act as an economic unit. *See supra* note 34 and accompanying text. To the extent that the joint return is premised on the assumption that spouses actually split their income, though, there is no theoretical reason to exclude unmarried cohabitating couples from also splitting their income. The justification, as far as there is one, is likely more practical: marriage may be *prima facie* evidence that a couple think of themselves as a unit, whereas a cohabitating couple may be an economic unit or may be roommates who split the cost of housing and nothing else. *See* Patricia A. Cain, *Federal Tax Consequences of Civil Unions*, 30 CAP. U.L. REV. 387, 407 (2002). Still, in light of the formal relationships established by civil unions and same-sex marriages, such a justification is less persuasive. *Id.* ("[I]n Vermont, civil unions create a bright line as well."). Moreover, such a justification may not reflect contemporary economic realities. *See, e.g.*, Wendy Richards, *An Analysis of Recent Tax Reforms From a Marital-Bias Perspective: It Is Time to Oust Marriage From the Tax Code*, 2008 WIS. L. REV. 611, 636 (2008) ("Many Americans operate as a family outside the traditional confines of marriage. Roommates often share expenses and pool incomes, and some parents choose not to get married while raising their children. Same-sex couples are not able to get married in most states, even if they otherwise function like the traditional family.").

that she would have received had she not made a gift of the property.[128] For such cohabitating couples, in fact, the level of control over the property and economic benefit from the income should be even more direct than had they given the property to their, or any other, child.

There are some limitations on how much income can be shifted—because couples other than heterosexual married couples are not treated as married for tax purposes, they are subject to the gift tax if they transfer more than the prescribed exclusion amount.[129] But transfers to children—even a person's own children—are also subject to the gift tax. Besides the fact that a married person can transfer twice as much to an individual without being subject to the gift tax,[130] there is no significant tax impediment to a person's shifting her income tax liability from income-producing property while still enjoying the benefits of the income.

Even more glaring than its inability in many cases to discourage the shifting of future income is that in most cases, the kiddie tax does not prevent the shifting of unrealized appreciation. Under current law, giving a gift is not treated as a realization event.[131] Instead, the built-in gain is carried over to the donee, who will not

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[128] That is, as a private matter, she should continue to exercise the same control over property she gives to her partner with whom she acts as an economic unit. Her legal rights, however, may be different than the legal rights of a heterosexual married person—in certain circumstances, such as bankruptcy, an unmarried person who gives property to her partner may not be able to exercise complete control over that property. *See, e.g.*, Jackie Gardina, *The Perfect Storm: Bankruptcy, Choice of Law, and Same-Sex Marriage*, 86 B.U.L. REV. 881, 889-90 (2006) ("Absent a legal marriage, for example, there is no guaranteed joint responsibility to the partner and to third parties (including children) in such areas as child support, debts to creditors, or taxes. In short, these property rights exist only in the context of a legally valid marriage.").

[129] The exclusion amount is $10,000, adjusted for inflation. I.R.C. § 2503(b)(2). For 2010, the amount is $13,000. Rev. Proc. 2009-50 § 3.30(1). *But see infra* Section V.A.3 for a discussion of the effectiveness of the gift tax at preventing income-shifting transfers.

[130] A gift by one spouse to a third party is treated, for gift tax purposes, as given half by one spouse and half by the other. I.R.C. § 2513(a). As such, a married person can double the size of her gift without its being subject to the gift tax.

[131] Marjorie E. Kornhauser, *The Constitutional Meaning of Income and the Income Taxation of Gifts*, 25 CONN. L. REV. 1, 43 (1992) ("[A] gift remains largely a nontaxable event for donors for income tax purposes . . . .").

realize any gain until she sells the property.[132] Because capital gains are unearned income for purposes of the kiddie tax, if the child were to sell it while still subject to the kiddie tax, it would be taxable at her parents' rate, and so the kiddie tax discourages transfers of property that a high-income taxpayer wishes to sell immediately. But if the child were to wait to sell it until after she is eighteen, or is otherwise not subject to the kiddie tax, it would be taxed at her (presumably lower) marginal rate. In addition, as with income-producing property, the kiddie tax does not prevent the transfer of appreciated property to other adults, including domestic partners and same-sex spouses, whether or not the donee is in a lower tax bracket than the donor. Although long-term capital gains are taxed at an advantageous rate—currently 15 percent for most people—provided the donee is in one of the lowest two tax brackets, under current law, she does not pay any tax on the gains at all. If the owner of appreciated property were to give that property to another adult in one of the lowest two tax brackets, even if the donee is the owner's partner or same-sex spouse, the donee could immediately sell the property, realizing the gain, and the built-in gain would never be taxed.

Although the kiddie tax effectively discourages highly-taxed individuals from shifting the tax burden on income-producing property to children, it is nonetheless severely underinclusive. Even with the kiddie tax, a high-income taxpayer can shift income to lower-taxed adults, in some circumstances in spite of the fact that the other adult is, for practical purposes, as much an economic unit with the donor as a heterosexual spouse would be. Moreover, the kiddie tax does nothing to prevent shifting the tax burden on unrealized appreciation to somebody in a lower tax bracket.

V. Preventing Tax-Motivated Income-Shifting Through the Income Tax Treatment of Gifts

Although a progressive income tax cannot be entirely efficient, Congress should weigh efficiency considerations as it creates tax

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[132] The donee will be taxed on unrealized appreciation when she sells the property because she takes the property with a carryover basis equal to the donor's adjusted basis in the property immediately before the gift. I.R.C. § 1015(a).

law.[133] As has been demonstrated, the kiddie tax produces distortions in children's economic decision-making, and is thus inefficient. Although it was intended to correct a distortion created by the imposition of a progressive income tax, it is both over- and underinclusive, increasing the rate of tax on more of a child's income than just the income shifted to her to reduce taxes while failing to discourage income-shifting in many situations. Still, in spite of its problems, the kiddie tax does address a real distortion. Merely eliminating the kiddie tax would return tax-motivated income-shifting to its pre-1986 status, itself an overcorrection of the problem. Without the kiddie tax (or some other solution to the problem of income-shifting), parents could again reduce the aggregate tax on familial income by giving income-producing assets to their children.

Even without enacting the kiddie tax, the Tax Reform Act of 1986 would likely have reduced the problem of income-shifting. It significantly reduced the highest marginal tax rates and reduced the number tax brackets to two, both of which limited the opportunity to shift taxes and the dollar value of doing so.[134] As tax brackets have proliferated, though, tax-motivated income-shifting has regained some of its prior luster. The highest two marginal rates of tax are likely to increase again,[135] and the Obama administration has proposed introducing a third, higher rate of tax on long-term capital gain and ending the advantageous rates on gains on the sale of investment assets held for longer than five years.[136] All of these changes would exacerbate distortions inherent to a progressive system and make income-shifting more attractive than it currently is. In light of the

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[133] *See, e.g.*, Nancy C. Staudt, *The Theory and Practice of Taxing Difference*, 65 U. CHI. L. REV. 653, 664 (1998) ("[T]he optimal theory of taxation . . . prescribes tax rules that minimize the distortion of individual decisions in the free market.").

[134] *See* Jean T. Adams, *Reconciling Family Law With Tax Policy: Untangling the Tax Treatment of Parental Trusts*, 46 TAX L. REV. 107, 111 & n.10 (1990) ("[T]he Tax Reform Act of 1986 greatly reduced the tax avoidance potential of assignment of income devices by reducing bracket differentials . . . .").

[135] Jackie Calms, *Obama's Pledge to Tax Only the Rich Can't Pay for Everything, Analysts Say*, N.Y. TIMES, Aug. 1, 2009, at A10 ("In the budget, Mr. Obama and Congress have already agreed to let the Bush tax cuts for the most affluent expire after 2010, as scheduled, but to extend them for everyone else. The top rates, now 33 percent and 35 percent, will revert to Clinton-era levels of 36 percent and 39.6 percent.").

[136] DEPT. OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2010 REVENUE PROPOSALS at 77 (May 2009).

increased likelihood that high-income taxpayers will be more likely in the future to engage in tax-motivated income-shifting and in light of the kiddie tax's ineffectiveness at preventing many income-shifting strategies, it is necessary to look at other possible solutions to the problem.

A. Changing the Tax Treatment of Gifts

Professor Schenk has stated that, assuming the kiddie tax is unsatisfactory, there are two alternatives to fix it: either compress the tax brackets or tax children's income on their parents' returns.[137] This Article presents a third way, one that acknowledges that shifting income to children is only one facet of tax-motivated income-shifting and that intends to eliminate income-shifting between any two taxpayers with different incomes. In order to more effectively discourage tax-motivated income-shifting, Congress should repeal the kiddie tax and, instead, replace it with two changes to the current income tax treatment of gifts.

As has been discussed, the kiddie tax only targets one of the distortions that makes income-shifting possible.[138] The difference in marginal rates certainly provides highly-taxed individuals with *motivation* to transfer income-producing assets to lower-taxed individuals, but the income tax treatment of gifts provides the means to shift income. Currently, a gift is excluded from a donee's income,[139] and the donee's basis in the gift is the same as the donor's basis was immediately before the gift.[140] Because basis is used as a placeholder for the amount of after-tax dollars invested in an asset, the donee will eventually be taxable on all of the unrecognized gain in the asset and so, by negative inference, the donor does not realize taxable income upon making a gift of appreciated property.[141]

This lack of any income tax on donors or donees at the time a gift is made makes gift-giving a very attractive means of income-shifting. Because there is no tax consequence upon making a gift, for

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[137] Schenk, *supra* note 36, at 151. In order to minimize complexity, she favors a reform of the kiddie tax that would tax childrens' income on their parents' return. *Id.* at 152.
[138] *See supra* Section IV.B.
[139] I.R.C. § 102.
[140] I.R.C. § 1015.
[141] *See, e.g.*, Mary Louise Fellows, *A Comprehensive Attack on Tax Deferral*, 88 MICH. L. REV. 722, 762 (1990).

tax purposes, there is no significant counterbalance to the tax advantages of making the gift. To the extent she continues to exercise control over or receive benefit from the transferred asset, the donor should be indifferent economically to whether she holds the asset or her child, spouse, or partner holds the asset. Moreover, because she recognizes no income at the time she receives the asset, the donee should be equally indifferent, for tax purposes, to receiving the gift. When making a gift will lower the total amount of taxes paid, then, there is no compelling reason for the donor to refrain from making the gift. That is, the motivation for income-shifting derives not solely from the marginal tax rate the donee pays, but from the tax treatment of gifts. In order to truly solve the problem of income-shifting, a provision, such as the kiddie tax, that focuses solely on the characteristics of the donee will never fully solve the problem. Instead, Congress must reform the tax treatment of gifts.

Because gifts are not included in a donee's gross income and the giving of a gift does not represent a realization event to the donor, there are two broad approaches that the tax law could take in order to reform the tax treatment of gifts: the tax law could include the gift in the donee's gross income or could treat the making of a gift as a realization event to the donor. Either one would, on its own, correct some of the distortionary effects of the progressive tax law, discouraging highly-taxed individuals from making gifts of income-producing property to lower-taxed individuals in order to reduce the aggregate taxes paid. But enacting only one of the changes would not fully counteract the incentive to shift income. If, for example, gifts were be includible in gross income, the donee would be subject to an immediate tax on the fair market value of the asset received. Even if the donee were in a significantly lower tax bracket than the donor, such an upfront tax liability would diminish the tax advantages of future income being taxed at a lower marginal rate. But it would not entirely eliminate the tax advantages in the case where the present value of the donor's future taxes was less than the present value of the donor's future taxes on the income plus the amount of tax she would pay upon receipt of the gift.[142] Combining the two proposed changes to the gift tax, however, would virtually eliminate the incentives underlying tax-motivated income-shifting to any person, not just

[142] This could be the case where, for example, the asset had a low fair market value on the date of the gift, but was expected to produce significant income in the future.

children, while, at the same time, allow the elimination of the kiddie tax and the distortions it presents to children's motivation to save or invest.

1. Gift-Giving Should Be a Realization Event

The U.S. system of taxing gains is predicated on a taxpayer's realizing the gains. Although it does a poor job of reflecting a taxpayer's economic income, the realization system is unlikely to be supplanted.[143] Because realization generally involves the sale or other monetization of an asset, it is easy for a taxpayer to determine the amount of her gain and, because she has monetized her asset, she has the cash available to pay tax on the gain.[144] But the realization rule also provides opportunity for shifting unrealized appreciation to lower-taxed individuals and other tax avoidance techniques.[145]

Because there is no tax consequence to the donor upon transferring property, there is no countervailing incentive to prevent her income-shifting. The treatment of gifts, in fact, produces a distortion of its own: where an individual wants to make a gift, it is in her best interest to give a gift of appreciated property rather than cash. If she were to sell the property and make a gift of the proceeds from the sale, she would be taxed on her gain in the property. But by giving the property instead, the donor will never be required to pay taxes on any unrealized appreciation.

Moreover, gifts of appreciated property (which, if the property does not provide income to its holder, is not affected by the kiddie tax) potentially provide as much opportunity for income-shifting as do gifts

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[143] There are discrete areas in the tax law that employ mark-to-market accounting, which reflects economic income better and which prevents a number of distortions caused by the realization system. In spite of the theoretical superiority of mark-to-market accounting, however, taxpayers may run into valuation and/or liquidity problems and, therefore, mark-to-market accounting is unlikely to expand significantly beyond the investment areas in which it may currently be applied. *See* Samuel D. Brunson, *Taxing Investors on a Mark-to-Market Basis*, 43 LOY. L.A. L. REV. __, __ (2010).

[144] *See* Yariv Brauner, *A Good Old Habit, or Just an Old One? Preferential Tax Treatment for Reorganizations*, 2004 B.Y.U.L. REV. 1, 7 (2004) ("The realization requirement is considered necessary since without it, valuation hardship and liquidity concerns may arise and cause the system to be perceived as unfair.").

[145] Mitchell L. Engler, *Progressive Consumption Taxes*, 57 HASTINGS L.J. 55, 64 (2005) ("The realization requirement raises a number of income tax avoidance opportunities . . . .").

of income-producing property. Under current law, most taxpayers pay taxes of 15 percent of their gains on property; taxpayers in the lowest tax brackets, however, pay no taxes on such gains.[146] That is, if a person in the highest tax bracket has property with a basis of $10 and a fair market value of $110, she will have taxable gain of $100 when she sells the property,[147] will be liable for $15 of tax, and will keep $95 of the proceeds (*e.g.*, $85 of gain plus $10 of recovered basis) for herself. If, however, she transfers the property to a person in one of the lowest two tax brackets, the donee can sell the property, incur no tax liability, and keep all $110.[148]

Treating the giving of a gift as a realization event would correct the distortions that lead to income-shifting far better than the kiddie tax.[149] If giving a gift were a realization event, a high-taxed person could not shift the incidence of taxation on unrealized gains to a lower-taxed person. Treating the giving of a gift as a realization event would prevent a category of income-shifting that the kiddie tax does not even address. Moreover, it would prevent a taxpayer from shifting this income to anybody, not just to children.

In order to prevent taxpayers from artificially triggering deductible losses, though, a gift must be treated as a realization event only as relates to unrealized gains. The purpose behind changing the tax treatment of gifts is to counterbalance distortions caused by a progressive tax system, not to provide balance between gains and losses. If giving depreciated property were treated as a realization event, a taxpayer could take advantage of the timing option, accelerating her losses by giving away depreciated property while not necessarily ceding control over the property.[150] If a person wants to both realize a loss and make a gift, she still has the ability to sell the

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[146] I.R.C. § 1(h)(1)(B), (C).

[147] Her gain on the sale of the asset is calculated as the proceeds from the sale less her adjusted basis in the property. I.R.C. § 1001(a).

[148] Under President Obama's budget proposal, the marginal rate of tax on those in the highest two income tax brackets would rise to 20 percent for taxable years beginning after 2010. *See supra* note 115. At 20 percent, the incentive to shift capital gains to lower-taxed individuals increases more and, because there are three marginal rates on capital gains, the opportunity to shift gains increases, too.

[149] Lischer, s*upra* note 43, at 620 ("An income shift would not occur as to the built-in gain if the initial transfer of the appreciated property were to be deemed a realization event to the transferor.").

[150] David M. Schizer, *Balance in the Taxation of Derivative Securities: An Agenda For Reform*, 104 COLUM. L. REV. 1886, 1923 n.129 (2004).

property, taking the loss, and to make a gift of cash or other property. Alternatively, if she sincerely wants to make a gift of the depreciated property, she can make a gift of the property and give up her loss.

Treating a gift of appreciated property as a realization event introduces tax-induced distortions of its own into the donor's decision-making. Such a realization event can easily be avoided, either by not making the gift or by making a gift of cash or unappreciated property. These distortions may, however, produce a desirable result. To the extent that the purpose behind the gift was tax-motivated, rather than producing a distortion, a tax on the gift would counteract the distortion otherwise caused by the tax system. And if the donor decides to defer taxation on the asset and instead give the donee cash, she will pay tax on any gains in the asset at her marginal rate when she eventually sells the asset.[151]

2. Gifts Should be Included in a Donee's Gross Income

While treating the making of a gift as a realization event eliminates an aspect of income-shifting not addressed by the kiddie tax, and eliminates the tax incentive to engage in such income-shifting, it does not directly address the problem the kiddie tax was implemented to eliminate: the giving of income-producing property to a lower-taxed person. However, treating the gift as income to the donee would counteract the distortions that induce highly-taxed individuals to transfer income-producing property to lower-taxed individuals.

The exclusion of gifts from gross income is a matter of legislative grace: although donees could be taxed on the value of gifts they receive, Section 102 excludes gifts from gross income.[152] The repeal of Section 102 would greatly reduce the advantages of

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[151] Moreover, the donee may prefer cash over the receipt of some other asset. *See* Joel Waldfogel, *The Deadweight Loss of Christmas*, 83 Am. Econ. Rev. 1328, 1328 (1993) ("While it is possible for a giver to choose a gift which the recipient ultimately values above its price—for example, if the recipient is not perfectly informed—it is more likely that the gift will leave the recipient worse off than if she had made her own consumption choice with an equal amount of cash.").

[152] Kornhauser, *supra* note 131, at 5 ("The case of determining the constitutional meaning of income is not an exception to this rule. All interpretive roads lead to the same conclusion: "income" includes gifts.").

transferring income-producing property in order to shift the income to a lower-taxed individual.

Including the gift in a donee's gross income would do two things to diminish the tax advantages of transferring income-producing property. First, it would eliminate deferral. The donee would be taxable on the full value of the gift in the year she received it. The current value of income-producing property should correspond to the net present value of all future income streams from that property.[153] By taxing the donee on the value of the property when she receives it, the amount she would include in gross income should roughly approximate the present value of the future income she will received from the asset.[154]

Although including gifts in a donee's gross income would eliminate deferral, the fact remains that, in the donee's hands, the gift would be taxed at a lower rate than the rate that would have applied to the donor's future receipt of income from that property. The donee will pay taxes at a rate that could be as many as 25 percentage points lower than the donor's rate. If the front-end tax were the only tax, it is still possible that including the gift in the donee's gross income would produce tax savings. But the donee will be taxed a second time, too: when the property pays dividends, interest, or other income, she will be taxable on that income. The present value of the amount of tax to be paid by the donee is unlikely to precisely trace the present value of the amount of tax that would have been paid by the donor. At worst, however, including gifts in a donee's gross income significantly

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[153] John Burr Williams, THE THEORY OF INVESTMENT VALUE 55 (1938) ("The purchase of a stock or bond, like other transactions which give rise to the phenomenon of interest, represents the exchange of present goods for future goods—dividends, or coupons and principal, in this case being the claim on future goods. To appraise the investment value, then, it is necessary to estimate the future payments.").

[154] Because of the time value of money, a dollar today is more valuable than a dollar in one year. As a result, deferral of taxable income is valuable to taxpayers and harmful to the government. *See* Joseph Bankman & Thomas Griffith, *Social Welfare and the Rate Structure: A New Look at Progressive Taxation*, 75 CALIF. L. REV. 1905, 1937 (1987) ("Taxpayers who are able to delay recognition of income and accelerate recognition of expense are able to defer payment of tax. Because of the time value of money, deferral has a high value to the taxpayer and a high cost to the fisc."). Along the same lines, accelerating a taxpayer's recognition of future income should, in part, counteract the benefits of being taxed at a lower rate.

increases the amount of tax due and correspondingly diminishes the tax advantages of making a gift of income-producing property.

As with treating the giving of a gift as a realization event, including gifts in gross income, by itself, would not eliminate income-shifting. Treating gifts as gross income to the donee would be most effective if the donor and donee were part of an economic unit, but it would not always be the case that they were members of the same economic unit. It is not even clear that spouses always act as an economic unit, much less parents and children or unrelated persons. Ultimately, the additional tax would be imposed on the donee; if the donor were interested principally in reducing her own tax liability and did not consider herself part of the same economic unit as the donee, subjecting the donee to additional tax would not discourage the donor from making a gift of the property. Moreover, to the extent the gift was unexpected, the donee would be forced either to come up with the money to pay the tax, either by selling the gift or by some other manner, or to somehow disclaim the gift.[155]

Although it increases her current tax liability, including gifts in the donee's gross income has at least one practical advantage to the donee: her administrative burden is decreased. Because gifts are not included in gross income, a donee must take a carryover basis in property she receives.[156] This means that the donee must determine the donor's basis in the property, either when she receives the property as a gift or, at the latest, when she sells it. To the extent the donee is unable to learn the donor's basis in the property, the I.R.S. must try to discover the donor's basis and, if the I.R.S. is unable to learn the donor's basis, the donee may be treated as having a basis equal to the fair market value of the asset when transferred.[157] However, because

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[155] It is not always possible to disclaim gross income. Because gifts are not treated as gross income to the donee, it has, up until now, been irrelevant whether a taxpayer can disclaim a gift or not. If, however, gifts were to be included in gross income, the tax law would need to provide some mechanism by which donees who did not want to pay taxes on the gift could disclaim it. Perhaps the rules applicable to prizes could be applied. A prize can be disclaimed, and thereby not included in gross income, if the recipient was selected without any action on her part (such as entering a contest), the recipient is not required to provide future service, and the prize is paid directly to a governmental unit or to certain tax-exempt organizations at the designation of the awardee. I.R.C. § 74(b).

[156] I.R.C. § 1015(a).

[157] *Id.*

there is no realization event or income inclusion upon the making of a gift, the final option would allow any built-in appreciation at the time of the gift to go untaxed forever, and provides incentive for donors and donees to obscure the donor's basis in the property. If Section 102 were repealed, though, providing for a carryover basis would be unnecessary; instead, the donee's basis in the property would be the fair market value of the property when transferred.

Treating the giving of appreciated property as a realization event and the receipt of a gift as taxable income will not, of course, act as an impenetrable bar to shifting income. Nor is it intended to do so. Instead, changing the tax treatment of gifts is intended to prevent *tax-motivated* income-shifting. In a non-tax world, there may be reasons why a high-income individual would want to give income-producing or appreciated property to a lower-income individual. Where a person has non-tax reasons for making gifts of income-producing property to other people, a complete bar to the making of such gifts would be inefficient and distortionary.[158] The imposition of income tax on the giving and receiving of gifts is intended solely to eliminate tax advantages to making such gifts; in the absence of such tax advantages, if a donor wishes to make gifts, she should be permitted to make them.[159]

These modifications to the taxation of gifts admittedly would not be a perfectly accurate response to tax-motivated income-shifting. The most accurate response would be to look at taxpayers' motivation upon making a gift and, in the absence of a significant non-tax motivation, disallow the transfer for tax purposes.[160] But such an individual subjective test would be impracticable administratively. A taxpayer could shift her income and play the audit lottery.[161]

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[158] *See* Epstein, *supra* note 40, at 55 ("A sound tax is designed to interfere as little as possible with the ordinary decisions that individuals would make in the investment and consumption of their capital and labor.").

[159] *See* Helvering v. Gregory, 69 F.2d 809, 810 (2d Cir. 1934) ("Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes.").

[160] Essentially, this would function as an economic substance test writ large.

[161] *See* Yoram Keinan, *Playing the Audit Lottery: The Role of Penalties in the U.S. Tax Law in the Aftermath of* Long Term Capital Holdings v. United States, 3 Berkeley Bus. L.J. 381, 384-85 (2006) ("The probability of detection and audit combined with the magnitude of the penalties are the major expected costs of

Moreover, even upon audit, because her motivation would be subjective, it would require significant investments of time and other resosources by the I.R.S. in order to determine her true motivations. For large transactions with significant revenue dollars at stake, determining the motives underlying a transaction may be worth the time and expense, but, unlike large transactions, most, if not all, taxpayers make gifts. The cost in determining the motivation underlying each gift may not be worth the increase in revenue that would result. In this way, even the kiddie tax would be a better option than a subjective test. But the proposed taxes on gifts together are a more accurate tool than the kiddie tax for preventing income-shifting.

In addition to to its superior prophylactic qualities against tax-motivated income-shifting, the proposed treatment of gifts has another advantage over the kiddie tax: it will not deter children from investing or saving. The proposed treatment for gifts only affects the donor and the donee upon making and receiving a gift. It does nothing to increase the tax on income a child earns on savings and investment. Rather, she will be taxed at her own marginal rate on any savings or investment, whether she derives the income from property she has received as a gift or as compensation. Moreover, the additional administrative burden that results from a child's being required to calculate her income twice under the kiddie tax if she has unearned income is eliminated. Because her after-tax return will be higher and she will not face increased administrative costs as a result of saving or investing, the tax law will not distort her incentive to save and invest vis-à-vis her decision to consume.

3. Overlap Between This Regime and the Gift Tax Would Generally Be Immaterial

It is worth noting that there already exists a regime for taxing gifts outside of the income tax.[162] The gift tax was originally enacted in order to backstop the income and estate taxes and to prevent income-shifting.[163] If the income taxes proposed in this Article were

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underpayment of taxes. Accordingly, underpayments of tax is similar to gambling and is referred to as 'playing the audit lottery.'").

[162] I.R.C. §§ 2501-2524.

[163] Mitchell M. Gans & Jay A. Soled, *Reforming the Gift Tax and Making it Enforceable*, 87
B.U. L. REV. 759, 761-62 (2007)

passed, there would be some gifts subject both to the income tax and to the gift tax, arguably resulting in unfair double taxation.

Such double taxation would likely be rare, however. Because of the high lifetime exemption rate from the gift tax (an individual can make gifts worth, in the aggregate, up to $1 million over her lifetime without being subject to the gift tax[164]) and an annual exemption (of $13,000 in 2010[165]), the gift tax does not apply to most gifts and, as a consequence, raises very little revenue.[166] Moreover, the gift tax is difficult to enforce, and "substantial amounts of wealth are transferred without the payment of any transfer tax."[167] If the changes to the income tax treatment of gifts proposed by this Article were to be enacted, it would be worth revisiting the gift tax to evaluate whether the gift tax was still necessary to backstop the income and estate taxes. In the meantime, however, because few donors are subject to the gift tax, and even fewer pay it, few gifts would be taxed twice.

4. Fairness Considerations

Taxing a donor on unrealized appreciation when she makes a gift and requiring a donee to include the value of a gift in her gross income itself introduces certain distortions into taxpayers' decision-making process. Such taxes would apply to all gifts, not just those that were tax-motivated. As a result, they would almost certainly reduce the number of gifts given. Because the purpose behind this Article's proposal is to replace the kiddie tax with a regime that addresses income-shifting in a more focused way, it is possible that, in order to minimize these distortions, Congress would decide to exempt some gifts from the regime because they do not represent a risk of income-shifting.[168] To the extent that Congress wanted to exempt a class of

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164 I.R.C. § 2050(a).

165 Rev. Proc. 2009-50 § 3.30(1). The annual exclusion from the gift tax is adjusted for inflation each year using the consumer price index. I.R.C. § 2503(b)(2).

166 In 2005, the gift tax raised less than 0.1 percent of the overall revenue raised by the federal government. Gans & Soledad, *supra* note 145, at 760.

167 *Id.*

168 Requiring that all gifts, no matter how small, be included in income, while not impossible, would present both practical difficulties and popular push-back. "It would obviously be folly for an income tax to try to reach all gifts. It is unthinkable that taxpayers should be obliged to account in their returns for the value of all dinners and entertainment which they enjoy as guests, and even for cigars and 'lifts'—to use more of Kleinwächter's examples." Henry C. Simons, PERSONAL INCOME TAXATION 135 (1938). Professor Simons felt that, although line-drawing

non-abusive gifts, it could provide any of a number of exceptions to the rule, including a de minimis safe harbor that would allow small gifts to be exempt from inclusion in the donee's income and/or from triggering tax realization. Alternatively, Congress could provide an exemption for property that does not produce income from being included in a donee's gross income. Any such exemption, though, would be mandated by considerations outside the realm of tax policy, and would increase the tax code's complexity.[169] Because it would add complexity, any exception to the rule would need to be fully and fairly scrutinized, and the public benefit it provided would need to be commensurate with the complexity it added.

One area where an exception may have commensurate public benefit is in the area of charitable contributions. Under current law, a person may make a gift of appreciated property to a tax-exempt organization and receive a deduction for the fair market value of the property without being required to recognize and pay taxes on any unrealized appreciation.[170] This combination essentially creates a double subsidy to the giver: the value of the gift reduces her taxable income and the cost to her of the gift is her basis, not the full value of the gift.[171] To the extent that donors determine the amount they give

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would invite abuse, at the least, investment assets and major consumer items given as gifts should be included in the recipient's taxable income. *Id.* at 136.

[169] *See, e.g.,* William Lee Andrews III, *No Bull's Eye for "Targeted" International Tax Rules*, 18 VA. TAX REV. 781, 786 (1999) ("Despite the desirability of simplification, targeted tax provisions by their nature employ exceptions and add unique features to general rules that necessarily increases complexity in the system of tax compliance.").

[170] *See* Lawrence Zelenak, *Taxing Gains at Death*, 46 VAND. L. REV. 361, 401 (1993) ("Under current law, a taxpayer who makes a charitable donation during life of appreciated property generally may take an income tax deduction for the fair market value of the property, despite not having to recognize gain on the disposition.").

[171] *See* Charles T. Clotfelter, *Tax-Induced Distortions in the Voluntary Sector*, 39 CASE W. RES. L. REV. 663, 675-76 ("The individual income tax system encourages donations in the form of appreciated property such as stock or works of art as compared to cash. It creates this favoritism by subsidizing gifts of property in two distinct ways. First, the taxpayer receives a deduction for the market value of the asset. Next, the government generally forgives the tax liability on any capital gains that would have been due had the taxpayer sold the asset."). As an illustration, a donee wants to make a gift of $10,000 to her favorite charity. In a non-tax world she would be indifferent as to whether to make the gift in cash or in appreciated stock. In the taxable world, however, she would prefer to give appreciated stock. If she has

by the after-tax cost to them of the donation, this may encourage donors who own appreciated property to make more generous charitable donations.[172] Of course, to the extent donors look only at the amount received by the charitable organization, the double subsidy instead leaves the donor with more after-tax money as a result of making a charitable donation. Allowing charitable donors to give appreciated property without recognizing gain can lead to abuses.[173] But to the extent that Congress believes both that the double subsidy will induce increased giving and that such increased giving is socially beneficial,[174] exempting appreciated charitable donations from the realization regime may be advantageous, in spite of the fact that it

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income of $100,000, a $10,000 gift in cash or stock would be deductible and her taxable income would be $90,000. However, if she gives cash, the gift costs her $10,000. But if she has stock she purchased for $5,000 two years ago that is now worth $10,000, the cost to her of the gift is only $5,000, but she still gets to deduct the full $10,000. As such, she is better off making a gift of the appreciated stock.

[172] *See* C. Eugene Steurele & Martin A. Sullivan, *Toward More Simple and Efficient Giving: Reforming the Tax Rules for Charitable Contributions and Charitable Organizations*, 12 AM. J. TAX POL'Y 399, 425 (1995) ("Appreciated property, particularly appreciated stock, has historically been—by a considerable margin—the most important source of contributions to private foundations."). *But see* Daniel Halperin*, A Charitable Contribution of Appreciated Property and the Realization of Built-In Gains*, 56 TAX L. REV. 1, 36 (2002) ("Thus, I would argue that current law can be justified only by establishing that forgiveness of gain [upon making a charitable contribution] is clearly the most efficient way to increase charitable giving (in terms of the ratio of additional gifts to lost revenue). Moreover, I believe it is essential to establish that an efficiency advantage, if it exists, is large enough to justify the loss of equity. In my view, this case has yet to be made.").

[173] Under current law, a taxpayer cannot take an unlimited charitable deduction. I.R.C. § 170(b). Congress's motivation in limiting the charitable deduction was that some high-income taxpayers were not paying any taxes because of the amount of charitable deduction they were able to take. *See* S. REP. NO. 91-552, at 2108 (1969) ("The committee's attention was called to the fact that the unlimited charitable contributions deductions has allowed a small number of high-income persons to pay little or no tax on their income."). At least one of the high-income taxpayers targeted by Congress had eliminated his tax liability by donating appreciated securities to tax-exempt organizations. *See Millionaire Tax Dodgers Bless Loophole for Nun*, ST. PETERSBURG TIMES, May 8, 1969, at 1A.

[174] There is also the question of whether tax-exempt organizations would rather receive donations of property or of cash. Unless encouraging gifts of appreciated property increases the overall value of contributions it receives, a tax-exempt organization should ordinarily prefer to receive cash donations. "Gifts in kind impair the welfare of the recipient, which has to deal with property it may not want and which may be costly to sell." Halperin, *supra* note 154, at 29.

increases complexity and creates distortions in a person's economic decision-making.

In order for the proposed changes to be fair, moreover, in addition to considering whether to provide for a de minimis exception, the tax law must account for the provision of necessaries to a taxpayer's children. If payment for food, clothing, and other necessities were taxable to both the parent and the child, the tax law would at best make it more difficult for a parent to fulfill her support obligations and, at worse, cause her to provide less support than she would otherwise have provided.[175] Still, if payments to or on behalf of minor children were exempted from this regime, it would again be easy to shift income by giving appreciated or income-producing property to one's child.

Perhaps the best solution, then, would be to import the gift tax's concept that "transfers in satisfaction of an individual's obligation of support" do not constitute gifts.[176] Although neither the Internal Revenue Code nor the regulations expressly excludes such transfers in satisfaction of support obligations from the definition of gifts for purposes of the gift tax, both the Supreme Court and Congress have recognized that such transfers should not be treated as gifts subject to the gift tax.[177]

Importing the concept that amounts paid to satisfy a parent's support obligation should not be treated as gifts for tax purposes is not a perfect solution. The line dividing non-gift required support payments from taxable gifts is fuzzy and, among other things, depends on state law, meaning that whether a payment qualifies as a gift or not

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[175] For discussion of a parent's support obligations toward her children, *see supra* note 52 and accompanying text.

[176] John G. Steinkamp, *Common Sense and the Gift Tax Annual Exclusion*, 72 NEB. L. REV. 106, 113 (1993).

[177] *See* Dickman v. Comm'r, 465 U.S. 330, 341 (1984) ("Our laws require parents to provide their minor offspring with the necessities and conveniences of life; questions under the tax law often arise, however, when parents provide more than the necessities, and in quantities significant enough to attract the attention of the taxing authorities."); H.R. REP. NO. 97-201 (1981), *as reprinted in* 1981-2 C.B. 352, 393 ("In providing an unlimited exclusion for certain medical expenses and tuition, the committee does not intend to change the law that there is no gift [for gift tax purposes] if the person paving [sic] the medical expenses or tuition is under an obligation under local law to provide such items to the recipient.").

differs from state to state.[178] In certain circumstances, a parent's provision of a benefit to her children could be treated partly as the satisfaction of a support obligation and partly as a gift.[179] Still, although the support standard does not provide a clear line, it does provide the flexibility to consider individualized circumstances, including custom and a parent's ability to pay.[180] In spite of the complexity and uncertainty surrounding this standard, courts and the I.R.S. have managed to apply it over the years, and an alternative standard without the flexibility would be over- or under-inclusive in many, if not most, situations. Therefore, importing the transfers in satisfaction of support obligations standard from the gift tax is probably the fairest way to exclude necessary payments from

5. Revenue Effects

Although the proposed taxation of gifts is intended to prevent tax-motivated income shifting, it is likely that such a change would also provide additional revenue to the government. Even if it were to act as a complete bar on taxpayers' making gifts, it would stem the revenue loss that currently exists as a result of the underbreadth of the kiddie tax. That is, rather than giving income-producing property to others, highly taxed individuals would instead hold that property and pay taxes on the income it produced. Moreover, although they would continue to have the ability to defer tax on appreciated assets, if and

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[178] *See* Robert G. Popovich, *Support Your Family But Leave Out Uncle Sam: A Call For Federal Gift Tax Reform*, 55 MD. L. REV. 343, 361-62 (1996) ("Unfortunately, the imposition and extent of such support obligations are not uniform among the states. As state law is determinative of whether a legal obligation for support exists, and this legal obligation is in turn determinative of a gift for gift tax purposes, there is, in effect, an inconsistent application of federal gift tax laws among the states."); Beck & Ekman, *supra* note 76, at 1202-03 ("[T]here is a difference between the standard of support imposed by the laws of the various states and the common law, and the standard of support as set forth in the various tax cases which have considered the problem.").

[179] Robert B. Smith, *Should We Give Away the Annual Exclusion?*, 1 FLA. TAX REV. 361, 396-7 (1993) ("Nonetheless, transfers which are for support can surely be so luxurious as to involve a gift element.").

[180] *Id.* at 397 ("In general, support is a variable concept that adjusts with the ability to pay. . . . On the other hand, to some extent, support is also defined by what others who are similarly situated provide their children.").

when they sold the appreciated assets, they would pay tax on their gains at their higher rates.[181]

But this Article's proposal was not intended to act as an absolute bar on gift-giving. And if people continue to make gifts of appreciated or income-producing property to others, the combination of the new realization rule and the inclusion in the recipient's gross income of the value of the gift will both tax appreciation at the donor's higher rate and accelerate taxable income. By eliminating deferral, the government will receive revenue that otherwise would not have been collected until later, if at all.

B. Other Potential Impediments to Tax-Motivated Income-Shifting Would Not Be as Effective as the Proposed Changes

Changing the tax treatment of gifts is not the only way to combat income-shifting, of course. The tax law could be modified in a manner that was either far more modest, such as limiting reform to the kiddie tax itself, or far more radical, such as exchanging the realization system of accounting traditionally used for a mark-to-market system. Neither the modest nor the radical reform would be a more effective impediment to income-shifting than changing the tax treatment of gifts, though, and problems with each potential solution suggest that this Article's proposal is, in fact, a better solution to the problem.

1. Fixing Holes in the Kiddie Tax

To the extent that the tax law intends to focus primarily on preventing income-shifting to children, one possible solution would be to make hermetically-sealed changes to the kiddie tax, without touching the broader tax law, in order to simplify the administrative complexities and in order to prevent not only the shifting of future income streams, but the shifting of unrealized appreciation.

The manner of implementing such reforms, however, is not clear. Shortly after the original passage of the kiddie tax, Professor Schmolka proposed, in order to simplify the kiddie tax, to apply the compressed tax brackets applicable to trusts and estates to every person for whom a dependency deduction could be taken.[182] By

[181] If, however, they continued to hold the appreciated assets until death, the appreciation would never be taxed. I.R.C. § 1014(a).

[182] *See* Schmolka, *supra* note 5, at 117.

applying such a rate structure, in 2010, a child's income in excess of $11,200 would be taxable at the highest marginal rate.[183]

Such a change would discourage highly-taxed persons from transferring appreciated or income-producing property to children, because a child's income would almost immediately be taxable at the highest rates. But, even moreso than the current implementation of the kiddie tax, Professor Schmolka's proposal is overbroad: it would continue to encourage consumption over saving and investment by significantly reducing the child's after-tax return. In addition, because both passive *and* active income would be taxed at higher rates, it would also significantly discourage a child from working.[184] Where the current kiddie tax only discourages children from saving and investing, the proposed changes would discourage children from entering the world of money at all.

Moreover, any changes solely to the kiddie tax would continue the underinclusiveness of the current kiddie tax—they would do nothing to prevent tax-morivated income-shifting to lower-taxed adults. Because of the inherent overbreadth and underinclusivity of the kiddie tax, it is not clear why it should be maintained, even in a reformed format that provided for less administrative burden. To the extent that discouraging tax-motivated income-shifting should be pursued, it makes more sense to enact a regime that actually targets and prevents the abuse.

2. Replacing the Progressive Rate Structure with a Flat Tax

This Article has pointed out that the primary cause of tax-motivated income-shifting is the tax law's progressive rate schedule.[185] If the progressive rates cause the problem, then changing

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[183] Rev. Proc. 2009-50 §3.01. That in comparison with the $373,650 a child would have to earn to be in the highest tax bracket under current law. *Id.*

[184] A child would be discouraged from working because of the "substitution effect." McCaffery, *supra* note 52, at 1037 ("Substitution effects unambiguously lead the individual away from the taxed activity, as other goods or pursuits ('substitutes') become more attractive."). Because her family is unlikely to rely on her income in order to survive, her need to work is relatively elastic, and she can substitute leisure for work. *See id.* at 1038-39 ("But a good deal of evidence supports the proposition that the labor elasticity for secondary earners in general, and married women in particular, is higher than it is for primary earners, or husbands. ").

[185] *See supra* notes 53-58 and accompanying text.

the income tax from a progressive tax to a flat tax would presumably eliminate the distortions that make income-shifting attractive.[186] A flat income tax is an income tax with a single marginal rate applicable to all taxpayers.[187] If, for example, a flat income tax imposed a tax rate of 28 percent, a person who earned $10,000 would pay taxes of $2,800 and a person who earned $1 million would pay taxes of $280,000. Because each dollar of income would be taxed at the same rate, irrespective of the taxpayer's income, high-income individuals would not reduce the aggregate tax paid by transferring income-producing property to lower-income individuals.[188]

Since the 1950s, many commentators have argued that a flat income tax is the only fair tax.[189] Evaluating whether a flat rate schedule is fairer than progressive rates is beyond the scope of this Article. However, to the extent it is desireable to maintain some degree of progressivity in the income tax, that progressivity will limit a flat tax's ability to discourage income-shifting. In general, even the most committed supporters of a flat tax do not advocate a "true flat-rate tax [that] would tax all income . . .[,] starting with the first dollar,

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[186] *See* Joseph Bankman & Thomas Griffith, *Social Welfare and the Rate Structure: A New Look At Progressive Taxation*, 75 CALIF. L. REV. 1905, 1930 (1987) ("The specific provisions governing gifts, trusts, family partnerships, loans at below-market rates of interest, unearned income of minor children, and divorce or separation agreements can be attributed largely to the progressive rate structure. All of these provisions could be simplified or eliminated by switching to a proportionate tax.").

[187] John K. McNulty, *Flat Tax, Consumption Tax, Consumption-Type Income Tax Proposals in the United States: A Tax Policy Discussion of Fundamental Tax Reform*, 88 CALIF. L. REV. 2095, 2103-04 (2000).

[188] Charles E. McLure, Jr., *The Simplicity of the Flat Tax: Is it Unique?*, 14 AM. J. TAX POL'Y 283, 290 (1997) ("An additional benefit of a flat rate is that it would reduce the opportunities for tax arbitrage--the structuring of transactions intended to place taxable income of the hands of those subject to low marginal tax rates and deductions on the returns of those subject to high marginal rates. With all taxpayers subject to the same marginal rate, there would be relatively little benefit in shifting either income or deductions in an attempt to minimize tax.").

[189] *See* Barbara H. Fried, *The Puzzling Case for Proportionate Taxation*, 2 CHAP. L. REV. 157, 157 (1998) ("Over the past half century, the view that the only fair tax is a flat-rate tax has attracted support from a surprising range of political philosophers and pundits, including Friedrich Hayek, Ludwig von Mises, Milton Friedman, John Rawls, and Richard Epstein, along with Walter Blum and Harry Kalven in their famous 1952 essay.").

at the same rate."[190] Instead, for political or fairness reasons, they support a "degressionary version of a progressive tax, in which the first x dollars of income . . ., sufficient to cover basic needs, is taxed at a zero rate, and all income . . . above that is taxed at the same positive rate."[191]

It is easy to understand this concession to progressivity by supports of flat taxation. It seems unfair to tax people earning just enough to pay for necessities on their income, thus depriving them of the means to pay for housing, food, or clothing. Rather, whether an income tax has multiple tax rates or only one, "[a]t the lowest income levels, a tax system accommodates the declining marginal utility of money through low or zero rates on the income used to buy specified minimum levels of food, clothing, shelter, and other goods and services."[192] To the extent a single rate of taxation is desirable, then, it makes sense to provide an exemption for the amount of income necessary to acquire such necessities.

To the extent there is an exemption amount, though, the flat tax no longer discourages all tax-motivated income-shifting and, in certain circumstances, may make income-shifting more attractive than it currently is. For example, if income were taxed at a 28-percent rate, with an $8,000 exemption, it would make sense for any taxpayer with more than $8,000 of annual income to transfer income-producing property to somebody with less than $8,000 of annual income. The income earned on such transferred property would be taxed at a zero rate, 28 percentage points less than the rate at which it would have been taxed in the original owner's hands. In order to prevent tax-motivated income-shifitng, a proportionate income tax that included an exemption would have to keep the kiddie tax, with its over- and underinclusiveness, or would have to institute other steps, such as

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[190] *Id.* at 160-61.

[191] *Id.* at 161. For example, the flat taxed proposed by Robert E. Hall and Alvin Rabushka included a personal allowance that reduced taxable income. For 1995, the personal allowance would have been $16,500 for a married couple and it would have been tied to inflation. Robert E. Hall & Alvin Rabushka, THE FLAT TAX 144 (2d ed. 1995). In 1995, Rep. Richard K. Armey introduced a bill that would have replaced the current income tax with a flat tax. His proposal, too, included a standard deduction that would reduce a taxpayer's taxable income. Freedom and Fairness Restoration Act of 1995, H.R. 2060, 104th Cong. § 101 (1995).

[192] Alan L. Feld, *Fairness in Rate Cuts in the Individual Income Tax*, 68 Cornell L. Rev. 429, 459-60 (1983).

those presented in this Article, in order to discourage tax-motivated income shifting.

There is broad agreement among commentators that some level of progressivity in the tax system is desirable.[193] As long as any amount of progressivity exists in the tax system, though, a flat tax will not eliminate incentives taxpayers currently face to shift income. Because it would not solve the problem of income-shifting, there is no compelling reason to replace the kiddie tax by implementing a flat tax.

CONCLUSION

The kiddie tax, originally passed almost a quarter century ago in order to prevent the perceived problem of parents' shifting income-producing assets to their children, has been largely ignored by academics in the intervening years. When it has been considered, with the occasional notable exception, the consideration has been limited to discussing how the kiddie tax functions and how parents and children can adjusted their investment and savings strategies in order to avoid the complexity and punitive nature of the kiddie tax.

The kiddie tax should not be ignored, though. While it adds significant complexity to a child's determination of her tax liability, the kiddie tax is limited in its ability to prevent tax-motivated income-shifting. Although it makes gifts to children of income-producing property less attractive, it permits significant classes of tax-motivated income-shifting, both to children and to adults, while, at the same time, it distorts children's incentives to save and to invest vis-à-vis their incentives to spend their money immediately.

Moreover, there is no strong theoretical justification for aggregating a child's passive income with her parents' income. Although the justification for taxing a child's passive income at her parents' top marginal rate is putatively premised on the idea that a child is part of an economic unit with her parents, the justification is belied by the fact that only a portion of a child's income is taxed at her parents' rate. In any event, commentators have been questioning whether even married couples' incomes should be aggregated, or

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[193] *See, e.g.*, Martin J. McMahon, Jr. & Alice G. Abreu, *Winner-Take-All Markets: Easing the Case for Progressive Taxation*, 4 FLA. TAX REV. 1, 72 (1998) ("The principles of ability to pay, equal sacrifice, and mitigation of socio-economic inequality, all suggest that a winner-take-all society should have a tax system that is more progressive at the very top than for an incrementalist society.").

whether the assumption that a family operates as an economic unit is an accurate reflection of reality.

In order to prevent tax-motivated income-shifting without the inefficiencies present in the kiddie tax, this Article has proposed that the kiddie tax be repealed and that, instead, the tax law target income-shifting by changing the tax treatment of gifts. If giving a gift of appreciated property were treated as a realization event to the donor and the fair market value of a gift were included in a donee's gross income, the advantages of shifting current appreciation or future income would be significantly reduced. Instead, potential donors would make gifts only when they had non-tax reasons to do so, and the form of the gifts would be determined not by what was most tax-advantageous, but by what the donor wanted to give and the donee wanted to receive.

The proposal leaves some loose ends that need to be addressed. Most importantly, accounting for every gift made by every taxpayer is impracticable. It may be desirable to provide a de minimis safe harbor for small gifts; it is almost certainly desirable to exempt a parent's support of her children from this regime. It may also be desirable to exempt certain other transfers, such as the transfer of appreciated property to a charity. But these possible exceptions to the proposed tax treatment implicate non-tax considerations, and should be evaluated and debated. For tax purposes, there is no reason why small gifts, charitable gifts, or even support of children could not be taxed.

It will also be necessary to evaluate the continuting relevance of the gift tax, should this Article's proposals be implemented. It would no longer be necessary to impose the gift tax as a backstop to the income tax, and taxing a gratuitous transfer under both the gift tax and the income tax could subject gifts to an unreasonably high effective rate of tax. On the other hand, the gift tax may still serve to backstop the estate tax and, as a practical matter, the gift tax applies to very few gifts, so subjecting gifts to both the gift tax and the income tax may have little or no practical significance. Nonetheless, it would be valuable to examine the interaction between the proposed changes to the income tax treatment of gifts and the gift tax.