"Gifts, Gafts and Gefts" – The Income Tax Definition and Treatment of Private and Charitable "Gifts" and a Principled Policy Justification for the Exclusion of Gifts from Income

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"GIFTS, GAFTS, AND GEFTS"[1]—THE INCOME TAX DEFINITION AND TREATMENT OF PRIVATE AND CHARITABLE "GIFTS" AND A PRINCIPLED POLICY JUSTIFICATION FOR THE EXCLUSION OF GIFTS FROM INCOME

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1 Despairing of the confusion engendered by the application of different meanings to the term "gift" as it is used in the income and transfer tax areas, the late Judge Frank suggested in *Commissioner v. Beck's Estate*, 129 F.2d 243, 246 (2d Cir. 1942) that Congress should "use different symbols to describe the taxable conduct in the several statutes, calling it a 'gift' in the gift tax law, a 'gaft' in the income tax law, and a 'geft' in the estate tax law."

Gifts have been given special treatment by the income tax laws since the first post-16th Amendment tax statute was adopted in 1913.[2] The determination of how the income tax law should treat gifts raises a number of issues. For example: should gifts be given special treatment? If so, what should qualify as a gift? Should gifts to a private party be taxable to the donee? Should gifts to a private party be deductible by the donor? Should the donee's basis in a gift of property be determined by reference to the basis that the donor had, and should any modifications of the donee's basis be made because of transfer taxes or other costs incurred pursuant to executing the transfer? If gifts to charitable organizations are deductible,[3] should the definition of what constitutes a

2 The Revenue Act of 1913 excluded gifts from the donee's income. Act of October 3, 1913, ch.16, § II (B), 38 Stat. 167 (1913) (current version at 26 U.S.C.). That exclusion has been retained in the tax law and is currently located at § 102 of the Internal Revenue Code of 1986. The 1894 federal income tax law, which was struck down because large parts of it were held to be unconstitutional by the Supreme Court's decision in *Pollack v. Farmers Loan & Trust Co.*, 158 U.S. 601 (1895), taxed gifts of personal property as income, but did not tax gifts of realty. Act of Aug 27, 1894, ch. 349, § 28, 28 Stat. 509, 553. *See* 26 CONG. REC. 6820–25 (1894).

3 In this Article, we will not discuss the question of whether a deduction should be allowed for charitable gifts. For a discussion of that issue, see Jeffrey H. Kahn, *Personal Deductions—A Tax "Ideal" or Just Another "Deal"?*, 2002 L. REV. MICH. STATE UNIV.-DETROIT COLL. LAW 1.

gift be the same as the one employed in determining whether transfers between private parties are gifts?

One topic that this Article addresses is the question of the propriety of excluding gifts from a donee's income, an exclusion that has been part of the income tax law since the modern income tax was adopted in 1913.[4] A number of commentators have decried that exclusion and, contending that there is no principled justification for it, have urged that donees be required to include gifts in their income.[5] We take issue with that view and contend that there is a principled tax policy justification for excluding gifts from a donee's income. The justification lies in the goals and structure of the income tax system itself. In addition, in this Article, we will address the other questions raised above. We will not discuss a number of related items, such as the exclusion from income of devises and inheritances and the exclusion of life insurance proceeds, but will deal only with gifts, and only as to the income taxation of gifts. While much of what is written about the income tax treatment of gifts applies equally to devises and inheritances, there are additional issues that apply exclusively to the latter, especially as to the basis that a devisee or beneficiary acquires in inherited property. We have omitted discussion of devises and inheritances in order to sharpen our focus on the topic at hand.

We will discuss the effect of gift taxes on the income taxation of gifts, but we will not examine the merits of imposing a gift tax or other transfer tax. Transfer taxation is a major topic which, in many respects, operates independently of the income tax. The reasons for imposing gift taxes are entirely different from the purposes of the income tax.[6] Although the two types of taxes can operate simultaneously on the same transaction, it

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4 *See supra* note 2.

5 *See, e.g.*, HENRY C. SIMONS, PERSONAL INCOME TAXATION 56–58, 125 (1938); Joseph M. Dodge, *Beyond Estate and Gift Tax Reform: Including Gifts and Bequests in Income*, 91 HARV. L. REV. 1177 (1978); William Klein, *An Enigma in the Federal Income Tax: The Meaning of the Word "Gift"*, 48 MINN. L. REV. 215 (1963); Marjorie E. Kornhauser, *The Constitutional Meaning of Income and the Income Taxation of Gifts*, 25 CONN. L. REV. 1, 28–37 (1992); Lawrence Zelenak, Commentary, *The Reasons for a Consumption Tax and the Tax Treatment of Gifts and Bequests*, 51 TAX L. REV. 601, 602–03 (1996). For example, Professor Klein stated in his 1963 article that "there simply is no good tax policy reason for excluding gifts, or inheritances, from the income tax base and that consequently the term 'income' must, for tax purposes, be construed to include gifts." Klein, *supra*, at 224. Standing out in opposition to that view, Professor Alvin Warren concluded that gifts should be taxable either to the donor or to the donee, but not to both. Alvin Warren, *Would a Consumption Tax Be Fairer Than an Income Tax?*, 89 YALE L.J. 1081, 1088 (1980).

6 *See* ALAN GUNN & LARRY D. WARD, FEDERAL INCOME TAXATION 190 (5th ed. 2002).

is useful to isolate the discussion of each tax system and to refer to the other only to the extent of their interaction. To discuss the gift tax in any depth, we would have to examine the estate tax and the extent to which the former tax complements the latter. If we so expanded the scope of this Article, it would detract from our goal of providing a concentrated focus on what itself is a broad subject.

The question of whether there is a principled justification for the income tax's exclusion of gifts is of considerable importance. If there were no justification, not only would there be a strong case for a legislative repeal of the gift exclusion, but the judicial and administrative construction of the statutory exclusion would likely restrict its scope as far as it is feasible to do. The seriousness of the risk that a court might be led to read the exclusionary statute narrowly is evidenced by the urging of Professor William Klein that they do so. Asserting that there is no legitimate tax policy objective for the gift exclusion, in a 1963 article, Professor Klein listed several approaches that the courts might take in construing the statute. The approach that he preferred was that the "gift exclusion . . . be given as narrow an application as the language of the statute permits."[7]

Contrary to the more popular view among academics, we contend that not only is the gift exclusion consistent with income tax policy, it furthers and implements an important aspect of that policy—namely, that the payment of an income tax purchases the right to have the taxed income used by the taxpayer, or by someone else of the taxpayer's choosing, to acquire and consume societal goods or services. That contention supports the current exclusion of gifts from income. Also, as illustrated later in this Article, the identification of the function that the gift exclusion plays in furthering tax policy can be an aid to courts in construing the application of that provision, and sheds light on the issue of the standard that should be applied to determine whether a transfer to a charity should be deductible. It is not our position that it would be wrong to tax a donee; rather, it is our contention that the exclusion of gifts from income furthers one important tax policy and contravenes another, and the decision to exclude gifts is based on the making of a choice between those two conflicting tax principles.

The Article also addresses the question of the proper standard to be applied in determining whether a transfer to a private party qualifies for the gift exclusion. We conclude that the standard currently employed, while appropriate in most circumstances, should be modified to accommodate special circumstances. We also examine the current rules for determining a donee's basis in donated property and question

7 Klein, *supra* note 5, at 260.

whether the adjustments currently allowed to a donee's basis are appropriate. The Article discusses "net gifts" (i.e., gifts which generate a gift tax that the donee is required to pay by the terms of the gift) and questions the correctness of the controlling Supreme Court decision on the income tax treatment of such gifts.[8] Finally, we examine the unsettled status of the rules for determining whether, and to what extent, a transfer to a charity qualifies as a charitable gift. The resolution of the first issue discussed in this Article (the identification of a policy justification for excluding gifts) bears significantly on the resolution of the other issues listed above—i.e., the issues are interrelated.

I. THE EXCLUSION OF GIFTS FROM THE DONEE'S INCOME

Section 102(a) of the 1986 Internal Revenue Code[9] excludes gifts, bequests and inheritances from the donee's income. The income from a gift is included in the donee's income as is the gift of a right to income when the income is received.[10]

A. *The Currently Applied Definition of "Gift" for Purposes of the Exclusion*

Before examining the rationales of those who oppose the exclusion for gifts and our reasons for holding the contrary view, let us examine how the term "gift" has been defined by the Supreme Court. Later, we will consider how it ought to be defined.

The legislature has not provided a definition of the term "gift," although it does list in Code § 102 several transactions that do not qualify for the exclusion from income.[11] The Supreme Court defined the term in the 1960 landmark case, *Commissioner v. Duberstein*.[12] While several other Supreme Court decisions[13] of the same vintage

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8 *See infra* Part III.C.

9 Hereinafter referred to as "Code" or "I.R.C."

10 I.R.C. § 102(b) (2000); *see also* Treas. Reg. §§ 1.102-1(b), (c) (1956). Under certain circumstances, income from the donated property that is subsequently received will be taxed to the donor under the "Anticipatory Assignment of Income" doctrine. *See* DOUGLAS A. KAHN, FEDERAL INCOME TAX, 694–700 (4th ed. 1999). The anticipatory assignment of income doctrine is a special concept designed to prevent the manipulation of tax bracket rates and has no relevance to the issues discussed in this Article.

11 I.R.C. §§ 102(b), (c).

12 363 U.S. 278 (1960); *see also* Bogardus v. Comm'r, 302 U.S. 34 (1937) (defining the term gift as used in common language).

13 *See* Stanton v. United States, 363 U.S. 278 (1960) (consolidated with *Duberstein*); *see also* United States v. Kaiser, 363 U.S. 299 (1960) (holding that a union's payments to a striking worker were a gift). Because the Supreme Court's *Duberstein*

provide some insight into the judicial application of the gift exclusion, it is the *Duberstein* decision that is uniformly cited as establishing the meaning of the term.

The facts of the *Duberstein* case were that, over a period of years, Duberstein had obliged a business associate by giving the latter the names of potential clients.[14] Duberstein neither sought nor expected any recompense for that assistance.[15] The business associate, in appreciation of the assistance he had received, gave Duberstein a Cadillac automobile.[16] The Government contended that the value of the automobile was income to Duberstein, and the latter contended that it was excluded from income as a gift.[17] The tax court held for the Government,[18] and the Court of Appeals for the Sixth Circuit reversed.[19] The Supreme Court granted certiorari and consolidated *Duberstein* with another case (*Stanton v. United States*).[20] The Court faced the question of how the term "gift" should be defined for the purpose of the exclusion.

In *Duberstein*, the Government contended that the test for whether a transfer is a gift should be whether the transfer was made for personal as distinguished from business reasons, and the Government urged the adoption of a number of objective factors to apply that test.[21] The Court rejected the Government's position on the question of the standard to be applied.[22] The Court held that the determination of whether a transfer was a gift is a factual issue,[23] and so the Court held that the tax court's determination must be sustained since it was not clearly erroneous.[24] The Court laid down the standard to be applied in determining whether a transfer is a gift. The Court noted that a voluntary transfer of property without consideration is not necessarily a gift for income tax purposes. The mere absence of a legal or moral obligation to make the transfer is not conclusive.[25] Something more is required. The Court stated that "the

opinion deals with the consolidated cases of *Stanton* and *Duberstein*, the holding in *Stanton* is incorporated in that opinion. *Duberstein*, 363 U.S. at 278.

14 *Duberstein*, 363 U.S. at 280.

15 *Id.*

16 *Id.*

17 *Id.* at 281.

18 Duberstein v. Comm'r, 17 T.C.M. (CCH) 16 (1958).

19 Duberstein v. Comm'r, 265 F.2d 28 (6th Cir. 1959), *rev'd*, 363 U.S. 278 (1960).

20 361 U.S. 923 (1959).

21 *Duberstein*, 363 U.S. at 284.

22 *Id.*

23 *Id.* at 286.

24 *Id.* at 291.

25 *Id.* at 293.

most critical consideration" is the intention of the transferor and quoted with approval the statement, "What controls is the intention with which payment, however voluntary, has been made."[26] The Court defined a gift as a transfer that "proceeds from a 'detached and disinterested generosity.'"[27] That language of the Supreme Court ("detached and disinterested generosity") typically is quoted by courts in passing on the question of whether a transfer is a gift;[28] the question of whether a transaction was so motivated is a question of fact to be resolved by the trier of facts.[29] The Court also said that a gift is a transfer that is made "out of affection, respect, admiration, charity, or like impulses,"[30] but it is the "detached and disinterested generosity" language that has controlled the decisions in this area.[31]

1. Transfers to Employees and Their Spouses

The application of the Supreme Court's standard has not been without problems. One question that arose both before and after *Duberstein,* and as to which conflicting results were reached by the courts, is whether a voluntary transfer to an employee or to the spouse of a deceased employee could be a gift in certain circumstances.[32] Congress resolved that issue in 1986 by adding subsection (c) to Code § 102. Section 102(c) precludes the application of § 102(a)'s exclusion from income for transfers made "to, or for the benefit of, an employee."[33] Unless another exclusion provision applies, an employer's transfer of property to an employee will be included in the employee's

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26 *Id.* at 285, 286 (quoting Bogardus v. Comm'r, 302 U.S. 34, 45 n.8 (1937) (Brandeis, J., dissenting)).

27 *Id.* at 285. The language "detached and disinterested generosity" was quoted by the *Duberstein* Court from an earlier opinion of the Court in *Commissioner v. LoBue,* 351 U.S. 243, 246 (1956).

28 *E.g.,* Olk v. United States, 536 F.2d 876, 879 (9th Cir. 1976).

29 *See Duberstein,* 363 U.S. at 286; *see also* United States v. Kaiser, 363 U.S. 299, 304 (1960).

30 *Duberstein,* 363 U.S. at 285 (quoting Robertson v. United States, 343 U.S. 711, 714 (1952)).

31 *E.g., Kaiser,* 363 U.S. at 304; *LoBue,* 351 U.S. at 246; *Olk,* 536 F.2d at 879.

32 The principal issue after *Duberstein* concerned the treatment of payments to the surviving spouse of a deceased employee. After the *Duberstein* decision, the Tax Court changed its view and held with fair consistency that payments to a surviving spouse were income; but district courts fairly consistently held that such payments were excluded from income as gifts unless the employer was a corporation dominated by the family or there were other circumstances indicating that the payment was compensation. BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 10.2.4 (2d ed. 1989).

33 I.R.C. § 102(c) (2000).

income.[34] In our opinion, it is virtually certain that § 102(c) prevents gift exclusion treatment for a transfer made to the surviving spouse of a deceased employee even though not required of the employer by a preexisting agreement with the deceased employee. Although the employee is deceased, the payment to the spouse is made to a natural object of the employee's bounty in recognition of the employee's services, and therefore fits within the statutory language addressing transfers made "for the benefit of an employee." Moreover, while there is no discussion of the 1986 addition of § 102(c) in the Committee Reports to the 1986 Tax Reform Act, of which the amendment was a part, as noted above, the question of whether the § 102(a) exclusion applied to payments to surviving spouses was a significant issue at that time.[35] It is beyond belief that Congress would have intended § 102(c) to apply only to payments made to or on behalf of a living employee, and therefore would have intended to leave unsettled the question of how payments to a surviving spouse are to be treated. However, there is no authority as to whether § 102(c) applies in that situation, and at least one major treatise reached the opposite conclusion to ours.[36]

Notwithstanding the unrestricted language of the 1986 amendment, the Service states in Proposed Regulation § 1.102-1(f)(2) that an extraordinary transfer to a natural object of the transferor's bounty, who also happens to be an employee, can qualify for the gift exclusion of Code § 102(a) if not made in recognition of employment. So, a gift from a mother to her son will not be denied an exclusion merely because the son is an employee of his mother.

2. Tips

Although, in our view, the 1986 statutory amendment solved the employee issue, there are other issues that are not expressly resolved by the statutory language. Customers may pay tips to persons who provide them services but who are not their employees. Tips are a reward for good service, and the prospect of receiving them is an incentive to provide good service. The transfer is not a product of detached and disinterested generosity any more than is a voluntary payment to an employee. Tips and gratuities for services rendered are

34 *Id.* Some benefits to employees may be excluded under other provisions of the *Code*, but they cannot qualify for the gift exclusion provided by § 102(a). *See, e.g., id.* §§ 74(c), 132(a). The 1986 amendment also precludes the application of the § 102(a) exclusion to bequests made to employees.

35 BITTKER & LOKKEN, *supra* note 32, ¶ 10.2.4.

36 *Id.*

included in the recipient's income.[37] Indeed, the Supreme Court has stated that "[w]here the payment is in return for services rendered, it is irrelevant that the donor derives no economic benefit from it."[38]

If adequate tips were not paid to an employee, the employer would be required to increase the employee's wages or risk losing the employee's services. In effect, the customer votes on the amount of compensation the employee will receive according to the quality of the employee's work, of which the customer is the best judge. The tip effectively is made to the employee on behalf of the employer, and so constitutes constructive income to the employer, but the employer's constructive income is washed out by the deduction allowed for the employer's constructive payment to the employee. Tips truly are additional compensation to an employee.

3. Transfers to Non-Employees Whose Work Benefited the Transferor

Another problem exists where a voluntary transfer is made to someone who does not perform services for the transferor, but who does perform services from which the transferor derives enjoyment or other benefit. For example, if a football team holds a special day to honor a star player, and fans make "gifts" to the player on that day, should the "gifts" be excluded under Code § 102? While the star player does not provide services directly to a fan in the way that a waiter provides services to a customer, the fan does derive a benefit from the player's performance. However, the commercial connection between the fan and the player is too remote to require income treatment, and the "gift" is likely to be motivated by "detached and disinterested generosity"—i.e., to provide an expression of the fan's appreciation and affection for the player.[39] Although there is a commercial relationship between a fan and a player, it is not one for which there is an expectation that the fan will contribute to the player's compensation.

On the other hand, if a transferee's employer solicits donations to be made to the employee from others who enjoy the employee's services and makes it clear that such donations are essential if the em-

37 Cracchiola v. Comm'r, 643 F.2d 1383 (9th Cir. 1981); Treas. Reg. § 1.61-2(a)(1) (1995);

38 Robertson v. United States, 343 U.S. 711, 714 (1952). This language was quoted with approval by the Supreme Court in its *Duberstein* decision, and in footnote seven of that decision, the Court expressly noted that tips are included in income. Comm'r v. Duberstein, 363 U.S. 278, 285 n.7 (1960).

39 *See* Kralstein v. Comm'r, 38 T.C. 810 (1962), *acq.*, 1963-2 C.B. 4; Rev. Proc. 68-19, 1968-1 C.B. 810.

ployee is to be retained, then the donations may properly be characterized as compensatory to retain the benefits of the transferee's services. *Goodwin v. United States*[40] provides a good example. A pastor of a small church was paid a low salary. Members of the congregation made routinized and periodic cash "gifts" to the pastor, who likely would have left that pulpit if he had not received those "gifts" to supplement his salary. Regardless of whether the members of the congregation who made those gifts could be deemed to be the pastor's employer, the court applied *Duberstein* principles to hold that the so-called "gifts" were income to the pastor. An alternative approach that might have been taken (but was not) is to focus on the role of the transferee rather than on the intention of the transferor. We will explore later in this Article (in connection with our discussion of *Olk v. United States*[41]) whether such an approach is permissible under current law, and whether it is desirable to apply it in certain circumstances.[42]

Similarly, if the reason for making a transfer is that the transferor seeks to protect or expand a business relationship with the transferee's employer, the transfer does not qualify as a gift.[43] Also, a transfer that is made for the purpose of advertising a product should not qualify as a gift. For example, if an automobile dealer were to make a public display of "giving" a car to a star athlete in full view of a sizeable number of fans, the transfer should not be treated as a gift.

An especially interesting case that raises the question of the meaning of the *Duberstein* standard is the Ninth Circuit's 1976 decision in *Olk v. United States.*[44] We will defer discussion of that case until after examining the tax policy justification for the gift exclusion. First, however, we will set forth the current rules for determining a donee's basis in donated property. After examining the tax policy justification for the gift exclusion, we will return to an examination of the donee basis rules to question whether they should be modified.

B. Donee's Basis in Donated Property Under Current Tax Law

When a donee acquires property by gift, the donee takes the same basis in that property that the donor had immediately before the

40 67 F.3d 149 (8th Cir. 1995). Tips also can be put into this category of income. *See* Treas. Reg. § 1.61-2(a)(1).

41 536 F.2d 876 (9th Cir. 1976); *see infra* notes 128–46 and accompanying text.

42 *See infra* Part II.

43 *See Kralstein*, 38 T.C. at 810. *But cf.* Pellar v. Comm'r, 25 T.C. 299 (1955) (holding that a discount given to the daughter of a business associate in order to retain the latter's business did not constitute income to the daughter).

44 *Olk*, 536 F.2d at 876.

transfer took place.[45] The donated property is referred to as "transferred basis property" or as "substituted basis property."[46] This transferred basis rule was adopted in 1921 and has been retained in the tax law since then.[47] There is a limitation on the amount of basis that a donee can obtain from the donor. For purposes of determining the amount of loss that a donee subsequently realizes on a disposition of the property, and only for the purposes of determining a loss, the donee's basis at the time of receipt of the property cannot exceed the fair market value of the property at that time.[48] Thus, when a donee receives property whose value is less than the donor's basis, the donee will have two bases for the property: one basis equal to the donor's basis for purposes of measuring the amount of gain the donee will realize on a subsequent disposition of the property, and a different basis equal to the fair market value of the property at the time of the gift for purposes of determining the amount of loss the donee will realize on a subsequent disposition of the property.

A gift to a donee may incur the imposition of a gift tax to the extent that the gift is not protected by the annual exclusion, a deduction, or the unified credit.[49] In the Technical Amendments Act of 1958, Congress amended § 1015 by adding subsection (d) which provides that a donee's transferred basis in donated property is to be increased (but not above the fair market value of the property at the time of the gift) by the amount of gift tax paid with respect to that gift.[50] In the Tax Reform Act of 1976, Congress further limited the amount of gift tax that can be added to the donee's transferred basis.[51] Under current rules, only the amount of gift tax on the transfer that is attributable to the appreciated portion of the donated property (i.e., the amount by which the fair market value of the donated property exceeds the donor's basis immediately before the gift) can be added to the donee's transferred basis.[52] As was true previously, the addition to the donee's transferred basis cannot raise the donee's basis to a figure that is greater than the fair market value of the donated

45 I.R.C. § 1015(a) (2000).

46 *Id.* §§ 7701(a)(42)-(43).

47 *See* WILLIAM A. KLEIN ET AL., FEDERAL INCOME TAXATION 120 n.16 (12th ed. 2000).

48 I.R.C. § 1015(a).

49 *Id.* §§ 2501(a)(1), 2503(b), 2505, 2522, 2523.

50 Technical Amendments Act of 1958, Pub. L. No. 85-866, 72 Stat. 1640 (codified as amended in scattered sections of 26 U.S.C).

51 Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1784, 1834, 1877 (codified as amended in scattered sections of 26 U.S.C.).

52 I.R.C. § 1015(d)(6).

property at the time of the gift. The method for determining the amount of gift tax that is attributable to the appreciated portion of the donated property is described in Treasury Regulation § 1.1015-5(c).[53]

C. The Tax Policy Justification for Excluding Gifts from Income

1. The Reasons Offered for Including Gifts in Income

The earliest and most prominent commentator to dispute the gift exclusion and urge that gifts be included in income was Henry C. Simons. In his seminal book, *Personal Income Taxation*,[54] Simons formulated a concept or definition of personal income that impliedly included gratuitous transfers.[55] Simons rested his rejection of a gift exclusion on his concept of personal income and on the tax policies that are reflected in that concept. Simons's concept of personal income is commonly referred to as the "Haig-Simons definition." Subsequent proponents of taxing gifts to the donee similarly rested their position on their construction of the Haig-Simons concept of personal income and the tax policies reflected therein.[56] Let us then examine that concept and the tax policies that it reflects.

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Simons defined personal income as

> [t]he algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in value of the store of property rights between the beginning and the end of the period in question. In other words, it is merely the result obtained by adding consumption during the period to "wealth" at the end of the period and then subtracting "wealth" at the beginning.[57]

This formulation (the so-called "Haig-Simons definition") is aimed at measuring an individual's ability to bear a portion of the cost of government on the premise that the cost should be borne by members of the public in proportion to their means to do so. As Professor William Andrews observed, the Haig-Simons formulation might best be described as an equation rather than as a definition—i.e., it is akin to the familiar equation that assets equals liabilities plus net worth.[58] Andrews suggests that instead of saying that income means consumption plus accumulation, it is more accurate to say that "an ideal per-

53 Treas. Reg. § 1.1015-5(c) (as amended in 1995).

54 SIMONS, *supra* note 5.

55 *Id.* at 56–57, 125.

56 *See, e.g.*, Dodge, *supra* note 5, at 1183 n.30; Klein, *supra* note 5, at 226–27.

57 SIMONS, *supra* note 5, at 50.

58 William D. Andrews, *Personal Deductions in an Ideal Income Tax*, 86 HARV. L. REV. 309, 315 (1972).

sonal income tax is one in which tax burdens are accurately apportioned to aggregate personal consumption plus accumulation."[59]

The term "consumption" is not defined in that formulation. We will discuss the meaning of that term later in this Article.[60] For now, we will adopt the definition that Professor Warren used—namely that "'consumption' means the ultimate use or destruction of economic resources."[61] Warren defined "economic resources" as the goods and services that are generally the subject of market transactions in our society, expressly excluding psychic benefits.[62] We would add to Warren's definition the proviso that the "consumption" to which the Haig-Simons definition refers is personal consumption—i.e., consumption for the personal purposes of the consumer as contrasted to the use or destruction of economic resources for business or profit-making purposes. Any reference in this Article to "consumption" is to be understood to refer to personal consumption.

The effect of including current personal consumption in the equation is that the market value of the consumption itself is taxed. If *X* earns income which *X* promptly uses to purchase and consume services, *X* has none of the income remaining at the end of the accounting period, and yet *X* is taxed on the full amount of the income. There is no meaningful difference between taxing *X*'s income and taxing the consumption itself. What difference is there then between a consumption tax and an income tax? The difference is that a consumption tax imposes a tax when the taxpayer actually consumes some item or service. The tax on income that is accumulated and invested is deferred until that income is used for consumption. In contrast, while the income tax does tax current consumption, it also taxes income that is accumulated during the accounting period. It is the element of taxing accumulated income that distinguishes the two.

Although nominally aimed at measuring income, the Haig-Simons formulation is integrally associated with personal consumption. Indeed, the "income" of an individual can be viewed as a surrogate for consumption—measuring the value of the individual's current consumption plus the present value of the future consumption[63] that can be obtained by the use of the accumulated wealth. The

59 *Id.* at 316.

60 *See infra* Part I.C.3.

61 Warren, *supra* note 5, at 1084.

62 *Id.*

63 The actual cost of future consumption should be discounted to determine the present market value of that consumption, but because the accumulated wealth that will be used to purchase the future consumption can be invested and thereby grow to

taxation of income effectively is a tax on current consumption plus a tax on future consumption that will be enjoyed by the taxpayer or by someone else. The income tax subsumes an assumption that accumulated income will be used for consumption at some future date, and that it does not matter whether it is so used by the taxpayer or by someone else.

What is the justification for taxing current consumption? The aggregate members of society produce a pool of goods and services. In a simple economy, such as that employed in an agrarian society, the Government could simply take a share of those goods when they are produced and leave the division of what is left to the persons involved. Modern society is too complex for that to be a feasible system of taxation. So, instead, a tax is imposed on individuals according to their respective incomes.[64] Because the Government cannot conveniently capture a portion of the goods produced by society at their source, it captures their economic equivalent from the individuals who have acquired or ultimately will acquire the societal goods. The income that an individual receives represents the sum of current consumption, which in turn represents societal goods that the individual has acquired for his exclusive use, and future consumption, which represents the societal goods that will be purchased with the individual's accumulated income at a future date.

When an individual uses an amount of income for consumption purposes in the year in which the income was received, the individual has removed the purchased goods or services from the common pool, and they are no longer available to anyone else in society. Those goods or services are captured by the individual to the exclusion of everyone else. It is an appropriate scheme to tax individuals in accordance with the amount of societal goods they have taken to themselves to the exclusion of others, and the income tax system does that in regard to current consumption. In effect, because the Government cannot conveniently take its share of societal goods at their source, the goods are traced to the individuals who capture them, and each individual is taxed in proportion to the amount of societal goods that individual captured for his preclusive use. The common pool con-

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purchase a greater amount of consumption in the future, the present value of the future consumption can be seen to be approximately equal to the amount of wealth accumulated in the current year. Of course, the growth of current wealth will come in the form of income, whether ordinary income or capital gains, and that income will be subjected to income taxation unless it comes from inherited appreciation or tax-free investments; and so the taxation of income earned from savings does constitute a kind of double taxation.

64 *See* Warren, *supra* note 5, at 1085.

cept, which we will discuss below, has its detractors. But, as to the taxation of current consumption, the justification of preclusive use seems unobjectionable.

In certain circumstances, the tax law does not tax a person for his preclusive consumption, but the reason for such exclusions is that the factual circumstances that are present raise competing tax principles or economic issues that Congress deemed sufficient to warrant an exclusion from income. For example, an employee is not taxed on the receipt of certain fringe benefits that are described in specific Code provisions, such as Code §§ 119 and 132. Although the employee does consume those benefits, and so the failure to tax them violates the tax principles of horizontal and vertical equity, the competing principles (in the view of Congress) outweigh those considerations, or Congress concluded that there are societal and economic benefits of greater importance than income equity to excluding those items from the employee's income. The term "horizontal and vertical equity" refers to the principles that persons with the same amount of income should pay the same amount of income tax, and that persons with disparate amounts of income should pay different amounts of tax that correlate to the difference in their incomes. It is beyond the scope of this Article to examine whether those competing principles or economic objectives do outweigh horizontal and vertical equity principles. It is sufficient for current purposes to note that the tax treatment of such items is sui generis and does not contradict our statement of the fundamental principles on which income taxation is grounded.

But, what is the justification for taxing accumulated income? If one were to adopt the preclusive use basis for the income tax (incorporating the common pool concept), would that mean that accumulated income should not be taxed because no goods have been consumed yet? We make no such contention. To the contrary, our view, as explained above, is that the amount of income that is accumulated is properly taxed at that time because it represents the present value of the consumption that presumably will take place at some future date. In other words, an income tax differs from a consumption tax in that the income tax imposes a tax currently on the present value of future consumption instead of waiting until the future consumption takes place and taxing it then. While a case might be made for substituting a consumption tax for the income tax system currently in use, we do not address in this Article the question of which tax is preferable. It is important, however, to recognize that an income tax system incorporates a tax on the present value of future consumption.

Some of those commentators who urge that gifts be taxable have a different view of the justification for taxing accumulated income. Their view is that the earner's possession of the power to employ the income how and when the income earner chooses to do so is a sufficient reason to tax that accumulation.[65] For example, Professor Kornhauser maintains that Simons based the income tax on the individual's "power to control society's scarce resources," and that Simons meant by consumption, not private consumption, but the "power to affect consumption."[66] It is noteworthy that even in Kornhauser's view of the basis of taxation, consumption is closely associated with income in that the "power to affect consumption" is the source of taxing income.

The dependence of income determination on a taxpayer's personal consumption is evidenced by the Code's provision of a tax deduction for expenditures that do not constitute a personal consumption (referred to hereafter as "nonconsumption" expenditures).[67] If, in Year One, *Z* received $10 for services performed, and if *Z* did not spend that $10 in that year, *Z* will be taxed on the $10 of income. If *Z* spent $10 in Year One to purchase a personal consumption, *Z* will receive no deduction for that expenditure, and so *Z* will still bear the tax imposed on the $10 of income that *Z* received that year. But, if in Year One, *Z* made a nonconsumption expenditure of $10 (such as a payment for a business expense or for the production of income or to conserve income-producing property), *Z* would be allowed a tax deduction of $10, which effectively would negate the $10 of income she received. The effect of allowing the deduction is to delete the $10 of income from the tax base. Similarly, if instead of making the nonconsumption expenditure in Year One, *Z* made a $10 nonconsumption expenditure in Year Three, the $10 deduction allowed to *Z* in Year Three would effectively erase the tax burden that she endured for the $10 of income that she reported in Year One.

If the criterion for taxing income is, as Professor Kornhauser maintains, that the taxpayer obtained the "power to affect consumption," the taxpayer's actual use of the income for nonconsumption purposes should not affect the taxation of that income. To the contrary, however, a tax on income will not prevail permanently unless the taxpayer either uses the income for personal consumption purposes or has someone of his choosing so use it. If income measure-

65 *E.g.*, Kornhauser, *supra* note 5, at 32.

66 *Id.*

67 *See, e.g.*, I.R.C. § 62 (2000).

ment is not merely a surrogate for personal consumption, the two concepts are bonded together as tightly as are Siamese twins.

Some nonconsumption expenditures are treated as nonitemized deductions which are subject to limitations on the amount that can be deducted.[68] These limitations purportedly were adopted for administrative purposes—i.e., they are intended to relieve taxpayers of some of the burdensome recordkeeping requirements and to reduce the complexity of filling out income tax forms. A cynical observer might conclude that the true purpose of the adoption of many of these limitations was to increase revenue collections, and that deduction limitations was the form that was adopted because that was politically more palatable than would be an increase in tax rates. The adoption of those limitations for the purpose of political or administrative expediency does not contravene the point made in the paragraph above.

Kornhauser notes that the view of preclusive use as the basis for income taxation has its roots in the "common pool" concept that Thomas Hobbes advanced many years ago,[69] a concept which she and others have criticized as seriously flawed. But, even if the preclusive use concept were rejected, that does not eliminate the close tie that exists between the taxation of income and the consumption of that income. Because current consumption is taxed when it takes place, the tax on accumulated income should not be duplicated by taxing it a second time when it is used for consumption at a future date. A principle of income taxation must be that an individual, having paid an income tax on accumulated income, has the privilege to use that income for consumption without thereby incurring an additional income tax. We will discuss later the significance that this principle has to the resolution of the question of how gifts should be treated by the income tax law.

The Haig-Simons definition is regarded as an expression of an ideal to which the tax system should aspire.[70] It is an expression of good tax policy to which tax rules should conform unless a competing consideration outweighs the virtues of maintaining that policy. Tax reformers often use that definition as a standard against which tax provisions should be measured. For example, the concept of a "Comprehensive Tax Base" (CTB) is based on applying the Haig-Simons definition.[71] While there are reasons to question whether the income

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68 *E.g.*, *id.* § 68.

69 Kornhauser, *supra* note 5, at 30–31; *see* THOMAS HOBBES, LEVIATHAN 226 (M. Oakeshott ed., 1960).

70 *See* Kornhauser, *supra* note 5, at 28.

71 *See* Dodge, *supra* note 5, at 1183 & n.30.

tax law should adhere strictly to that definition,[72] we will accept the definition in this Article, but maintain that, contrary to Simons's assertion, some of the tax policies that are reflected in that definition support the exclusion for gifts.

Let us first examine the reasoning of those who contend that gifts should be included in income. The genesis of that contention lies with Henry Simons himself. Simons contended that the accumulation of wealth should be taxed regardless of how the wealth was obtained. Simons stated, "The income tax is not a tax upon income but a tax upon persons according to their respective incomes; and . . . the objective of policy must be fairness among persons, not fairness among kinds of receipts. . . ."[73] Simons also stated,

> Our definition of income perhaps does violence to traditional usage in specifying impliedly a calculation which would include gratuitous receipts. To exclude gifts, . . . would be to introduce additional arbitrary distinctions; it would be necessary to distinguish among an individual's receipts according to the intentions of second parties.[74]

In other words, receipts increase an individual's capacity to consume, and the income tax law should focus on that capacity and not on how the individual obtained it. If taken in isolation, this is a powerful argument. While Simons based his view of how gifts should be treated primarily on his conclusion that the underlying principles of an income tax system provide no basis for excluding gifts from income, he also suggested that an exclusion of gifts requires an inquiry into the subjective motives of transferors,[75] which Simons believed would impose an undue administrative burden on the taxing authorities. Experience with the administration of the gift exclusion has not borne out that fear, especially after Congress resolved the treatment of gifts to employees and their spouses in the 1986 amendment to Code § 102.

Subsequent proponents of including gifts in income have adopted Simons's view. For example, in his 1963 article, Professor Klein wrote,

> The idea that gifts should be treated as income for tax purposes was argued elaborately, articulately, and most forcefully by Simons in his

72 The late Dean Erwin Griswold wrote, "The economists have devoted a great deal of thought to the definition of the concept of income, but it must be confessed that it is difficult for a lawyer to get much concrete aid from their work." ERWIN N. GRISWOLD, CASES AND MATERIALS ON FEDERAL TAXATION 146 (6th ed. 1966).

73 SIMONS, *supra* note 5, at 128. This statement by Simons incorporates the principle of horizontal and vertical equity.

74 *Id.* at 56–57 (citations omitted).

75 *See id.* This is a prescient observation in light of the subsequent adoption of the transferor's intent as the critical test for classification as a gift.

> classic work, *Personal Income Taxation*, published in 1938. Simons' position is simply that for tax purposes there is no reason to distinguish gifts from other receipts: "it is hard to defend exclusion of certain receipts merely because one has done nothing or given nothing in return". . . . His attitude towards the taxation of gifts was basically determined by his view that taxes must focus on the individual and that the best objective measure of equality of individuals for tax purposes treats all forms of enrichment alike.[76]

Klein pointed out that Simons's view of the proper definition of income, including his view of the taxation of gifts, has been widely accepted by economists.[77]

In his 1978 article, Professor Dodge makes similar arguments for including gifts in income and cites Simons and the Haig-Simons definition in support of that view.[78] Dodge states that "it is axiomatic that receipts should be included in income regardless of source or nature."[79]

2. Double Income Taxation

As previously noted,[80] under the principles reflected in the Haig-Simons definition of income, the justification for taxing income that is accumulated, rather than spent in the year it was earned, subsumes an assumption that the accumulated wealth will be spent on consumption in some future year and that the amount of the income currently accumulated provides a fair approximation of the present value of the future consumption. Of course, there is no means of predicting whether the immediate taxpayer will be the one to use the accumulated funds to purchase services or goods at some future date or whether some other person will use the funds to enjoy the future consumption. Thus, the tax laws are indifferent as to who uses the accumulated wealth for consumption purposes; it is sufficient to assume that the wealth will be so used at a future date by someone, not necessarily by the current taxpayer.

The taxing of an individual's income entitles that individual to an equivalent amount of consumption, either in the year that the income is earned or in a future year, without incurring additional income taxes. Even if consumption were not deemed to be the keystone to the allocation of tax burden under the income tax system, and if "abil-

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76 Klein, *supra* note 5, at 226 (citations omitted).

77 *Id.* at 227.

78 Dodge, *supra* note 5, at 1183–84.

79 *Id.* at 1184.

80 *See supra* note 63 and accompanying text.

ity to pay" were deemed the sole criteria, once a taxpayer has paid income tax, the taxpayer should be permitted to employ that income in any way the taxpayer desires without thereby incurring any additional income tax. If a taxpayer transfers previously taxed income to someone else as a gift, can the taxpayer be deemed to have consumed it by making that gift? If the gift does not constitute consumption by the taxpayer, and if the gift is treated as taxable income to the donee, then there would be two sets of income taxation on a single consumption—i.e., the only consumption that would take place would be the consumption that occurs when the donee uses the donated property. Prior to the 1938 publication of Simons's book, some commentators characterized this treatment as "double taxation" and argued that gifts should be excluded to prevent a duplication of the income tax.[81] Professor Zelenak agrees that it is a double taxation, and that it can be justified only if the transferor can be viewed as consuming the transferred property by making the gift;[82] however, he ultimately concludes that double taxation is appropriate for gifts.[83] Simons expressly rejects the contention that there is double taxation on the basis that the gift itself is a kind of consumption by the transferor. Simons states,

> If it is not more pleasant to give than to receive, one may still hesitate to assert that giving is not a form of consumption for the giver. The proposition that everyone tries to allocate his consumption expenditure among different goods in such manner as to equalize the utility of dollars-worths may not be highly illuminating; but there is no apparent reason for treating gifts as an exception.[84]

Professor Dodge acknowledged that the taxation of gifts "involves 'double taxation' in the economic sense in that the grantor is giving after-tax dollars on which the recipient is again taxed," but Dodge opines that the problems engendered by double taxation can be mitigated by some other means.[85] Dodge states that, "the area of gifts . . . is not one where economic considerations should predominate over principles of tax equity."[86] Dodge distinguishes economic considerations from tax equity because he views the problem of double taxation exclusively as one of hindering capital formation, which could be cured by other means—i.e., he does not view the problem as one that conflicts with the principles of the income tax itself. Dodge believes

81 *See* SIMONS, *supra* note 5, at 57; Warren, *supra* note 5, at 1088.

82 Zelenak, *supra* note 5, at 602.

83 *Id.* at 603.

84 SIMONS, *supra* note 5, at 57–58.

85 Dodge, *supra* note 5, at 1185–86.

86 *Id.* at 1186.

that double taxation is warranted to preserve the proper measurement of the donee's income.[87] Dodge does state that, "[t]he giving of a gift is more analogous to consumption than to investment."[88] One might counter that statement with the observation that gifts are far from analogous to either one.

An important question then is whether a gift is a kind of consumption or something closely related to consumption. A gift does not exhaust any societal resource, and therefore cannot be considered even akin to a consumption. Consider the contrast between a gift of cash or property to a donee and a payment to a third party for services rendered. Take the example that Professor Klein set forth in his 1963 article to illustrate why he asserts that the intention of a transferor should not affect the income tax treatment of the transfer:

> [t]he argument attempts to establish a distinction based on the position of the donor rather than the donee. Surely no one would argue that if *X* pays his gardener 4000 dollars per year, the gardener should not be taxed because doing so interferes with *X*'s "right" to use his property. The argument is equally without merit in the case where *X* pays 4000 dollars per year to his son, out of pure love and affection. While *X* probably does not want his son to be taxed, he is not so concerned about the gardener. Tax consequences, however, cannot be permitted to turn on considerations such as this.[89]

The same argument was made by Victor Thuronyi, who wrote:

> it is not accurate to say that *the gift* is taxed twice. What is taxed is, first, the amount [of income] earned by the donor and, second, the amount transferred to the donee. The gift is taxed only once, to the donee. Thus, a gift is no more subject to double taxation than is a payment for personal services, which is also "taxed twice"—once when earned by the payor and again when received by the payee.[90]

This argument is fallacious. Take the facts of Klein's example. *X*'s payment to the gardener is a cost of obtaining the gardener's services which were captured by *X* and used for his benefit to the exclusion of the rest of society. The gardener's services were a societal resource that *X* consumed, so the payment is an expense for a consumption by *X*. Assume that the money that *X* used to pay the gardener was income that had been taxed to *X*. Having paid income tax on that income, *X* is entitled to use it for consumption without incurring an additional income tax. But, *X* did use it to pay for a consump-

87 *Id.* at 1188–89.

88 *Id.* at 1186.

89 Klein, *supra* note 5, at 259.

90 Victor Thuronyi, *The Concept of Income*, 46 TAX L. REV. 45, 74 (1990).

tion, and so *X* has obtained the consumption for which he was taxed. When the gardener receives the payment, he is taxed on that income because he can use it to purchase goods or services that he will capture for his exclusive benefit to the exclusion of the rest of society. Taxing the gardener on the payment he receives does not constitute a double counting of a single consumption. To the contrary, there are two separate consumptions or future consumptions, and so it is proper that there are two separate income tax impositions.

In contrast, when *X* makes a gift to his son, *X* has not consumed any of society's resources by making that transfer. The consumption will take place in the future when the son uses the donated property to pay for a consumption or the son uses up the donated property itself. It is the son's use of the property that is the consumption, not *X*'s gift to the son. Unlike the circumstance with the gardener, there will be only one consumption, but, if the gift to the son were to be included in his income, there would be two tax impositions on that one consumption—once on *X* when he earned the income that was the subject of the gift, and a second on the son when he received the gift. The difference between the two circumstances could not be more striking.

The fact that a transfer does not constitute a consumption does not mean that the transfer necessarily must be free of a second tax. As explained later,[91] the decision not to tax a gift rests on a weighing of two competing principles. In some circumstances, the facts that are present may raise a third principle that points towards taxing the transfer, or the facts may alter the weight to be accorded either of the competing two principles so as to change the balance. Part III illustrates some circumstances in which a transfer of what otherwise would be a gift should be taxed to the donee.

If the gift itself, in contrast to the donee's use of the donated property, were to constitute a consumption by the donor, then the case for taxing the transfer to the donee would be very strong. Professor Kornhauser argues that a gift does constitute a consumption by the donor because "[t]he donor gets personal satisfaction from benefitting [sic] the recipient."[92] A donor's personal satisfaction does not entail the use or destruction of an economic resource, which we maintain is the essence of a consumption. Kornhauser does not accept that definition of consumption; as noted above, she maintains that the "consumption" to which the Haig-Simons definition refers is the obtaining of a power to affect consumption. We, holding the view that

91 *See supra* Part I.C.4.

92 Kornhauser, *supra* note 5, at 30.

even the taxation of accumulated income is a tax on future consumption, do not agree that psychic pleasure constitutes a consumption.[93] Moreover, as discussed later in connection with examining the principle of permitting vicarious enjoyment,[94] the psychic pleasure that the donor derives from the transfer lies at the heart of the justification for not taxing it.

In certain circumstances, a person's use of an economic resource will be treated as a consumption even though the use is not preclusive and does not result in the destruction of that resource. Consider the following example. *X* creates a software program for computers. A person can purchase the use of that program and have it sent to his computer electronically, after which it can be used indefinitely by the purchaser. The transaction is one in which the purchaser obtains a permanent license to use the software. The purchaser's use of the software does not remove anything from society's common store of resources because the same program can be sent to the rest of the world, and the purchaser's obtaining of the program does not deny anyone else access to it. One might say that the specific electronic transmission that the purchaser received was obtained exclusively by that person, but it would be a stretch to classify that as a preclusive use of a societal resource. Why then should the money paid by the purchaser to obtain a license for the use of the software be treated as a consumption? When the software was created, that was a societal resource, a portion of which, in a simpler economy, could have been taken by the government as a tax. However, even if we had an elementary economy, the government could not easily take a portion of the software at the time of production because the producer would still be free to license it to as many persons as the producer chooses. While the government could restrict the number of persons to whom the producer can license the software, and the government could go into the business of licensing its share of the software, that is not a viable solution. Instead, the government can take a dollar amount which equals the value of a portion of the software, whose value can best be determined by waiting to see the extent to which the producer actually sells licenses to use it. In effect, the tax is deferred until licenses are sold, and the tax is imposed on the purchaser of each license by treating that purchase as a consumption of a portion of the software. So, for tax purposes, a portion of the resource can be con-

93 As previously noted, Professor Warren's definition of "consumption" explicitly precludes the pleasure derived from psychic benefits. *See* Warren, *supra* note 5, at 1084.

94 *See supra* Part I.C.3.

sidered to have been consumed at the time that the license is purchased. The situation is quite different in the case of personal satisfaction; in that case, no resource has been produced, and so none can be consumed.

If personal satisfaction were characterized as consumption, than a taxpayer who enjoyed personal satisfaction from the receipt of income (i.e., the pure joy of seeing his bank account increase), would be deemed to have consumed that income immediately upon receiving it. That would prove too much; but, in any event, even if that characterization were adopted, it would not alter the analysis set forth in this Article. A person who was deemed to have enjoyed a consumption because of the personal satisfaction of receiving income nevertheless would not be taxed again when the income is used to purchase the preclusive use of a societal resource. Regardless of how the psychic benefit obtained from receiving income is characterized, the taxpayer is entitled to employ that income for the preclusive use of a societal resource. Similarly, the psychic benefit derived from making a gift does not erase the right to use those funds to purchase the preclusive use of a societal resource.

As discussed later in this Article in connection with an examination of the income tax meaning of the term "gift,"[95] a donor may derive benefits from the donee such as the latter's gratitude and appreciation. Not all of those benefits can be described as psychic pleasure because they may be converted into influence over the donee. In Part II of this Article, we explain why those benefits, and the donor's possible anticipation of them, do not prevent a transfer from qualifying as a gift,[96] and the same reasons explain why they do not preclude the exclusion of such transfers from income. In short, one reason is that the donee's gratitude and appreciation are not limited societal resources, and so the "benefit" does not represent the consumption of a societal resource. But, there is a second reason that applies even if our view that consumption requires the exhaustion of a societal resource were rejected. The obtaining of gratitude and accompanying attitudes from the donee is an insubstantial benefit, and, in most cases, it will be virtually impossible to determine whether that was the motivating force for the transfer. The desire to provide the donee with the means of consuming the income that was transferred to the donee often will be the exclusive purpose of the transfer and will virtually always be the dominant motive. As stated in the quote above, Professor Kornhauser herself describes the benefit that the do-

95 *See infra* Part II.

96 *See infra* notes 147–49 and accompanying text.

nor obtains as the personal satisfaction derived from benefiting the donee. That personal satisfaction is incorporated in our contention below that the taxation of income in the hands of the donor provides the donor with the right to enjoy a consumption of the income either by consuming it himself or by having the vicarious enjoyment of having another of his choice consume it.

A person (a "donee") may "gratuitously" perform services for another in the hope that the latter will thereby be induced to make a gift of property. If a gift of property is made subsequently, does the donor's consumption of the donee's services satisfy the one-consumption principle so that the donee should be taxed on the gift? Our answer is no. In virtually all such cases, the value of the donee's services will be vastly less than the amount of the gift (otherwise, it would not be a profitable venture for the donee), and so most of the transfer cannot be matched to a consumption of the donee's services. Thus, only a small portion of the transfer can be matched by a consumption and so taxed to the donee, and the administrative burden of ascertaining the identity and value of those services would be enormous, if indeed it is even feasible. More importantly, a donee may have gratuitously performed the services with no ulterior selfish motives, and that is the most likely scenario in all but a few circumstances. The relationship of the parties makes gratuitous motives highly plausible. Cross giving is a common occurrence, and one gift is not deemed compensation for the other. It would be impossible in most cases to determine the motives that the donee possessed, and the reasonable presumption is that the donee's actions were not selfishly motivated.

Professor Kornhauser also points out that a donor might continue to use the donated property.[97] For example, if a donor (*Y*) makes a gift of an automobile to a spouse (*Z*), both might enjoy the use of the car. It is difficult to see the significance of that observation to the issue at hand. If *Y* did not make a gift of the car but retained it in *Y*'s name, both spouses might well use the car jointly. The use of the car by *Z* in that case would not likely be treated as a taxable event even by those who would tax gifts. *Y*'s joint use of the car after gifting it to *Z* is equally irrelevant.

The reason for not taxing *Y*'s gift of the car to *Z* is that the consumption of the car takes place when it is used, not by its transfer. *Y*'s joint use of the car after making the gift does not make the transfer itself a consumption by *Y*. If the car is consumed by the use of both *Y* and *Z*, there still is only one consumption that takes place, and there should be only a single income tax. The only relevance to *Y*'s joint use

97 Kornhauser, *supra* note 5, at 30.

of the car is to the question of who, between *Y* and *Z*, should bear the incidence of the single income tax, but because the current tax scheme places the incidence of the tax on *Y*, *Y*'s use of the car does not detract from that decision.

An additional reason for not treating a joint use of the car as a justification for taxing the gift is the adoption of a single unit concept, which is discussed later in the Article.[98] Under a single unit concept, which, in fairness, it should be noted that Professor Kornhauser rejects, the use of the car by both spouses would be irrelevant.

What is wrong with having two income tax impositions for a single consumption? The answer is that there is nothing wrong with it if there is a compelling policy goal that is furthered by such double taxation. The difficulty here is that, on balance, income tax policy considerations either weigh in favor of a single income tax imposition or, at least, are in equilibrium on that issue.

3. Vicarious Enjoyment of Another's Consumption

Let us consider *X*'s gift to his son, and again assume that the gift is of accumulated income on which *X* has been taxed. As previously noted, having paid tax on that income, *X* is entitled to expend an equivalent amount on consumption without incurring an additional income tax. But *X* decides that he does not wish to consume any more for himself. Instead, he wishes to enjoy vicariously a consumption by someone he loves, his son. As Simons might have put it, *X* will derive greater utility from enjoying his son's consumption than from consuming an item himself. The gift to the son implements *X*'s wish, but it will be partially frustrated to the extent the son is taxed on the gift, thereby reducing the net amount that passes to him, so that the son cannot purchase the same amount of consumption that *X* could have. The question then is whether the income tax system should permit a taxpayer to use the full amount of income on which he has paid income tax to enjoy vicariously a consumption by a loved one, or whether the system should permit a full amount of consumption only by the taxpayer himself. While either solution is possible, to allow the taxpayer to enjoy vicariously another's consumption is consistent with the tax policy of taxing accumulated income on the assumption that someone, not necessarily the taxpayer, will use the accumulated funds to pay for a consumption at some future date. In addition, providing the taxpayer the option of vicarious consumption implements the economic goal of minimizing the extent to which the tax system de-

98 *See infra* Part I.C.6.

presses the incentive to produce goods or services that will be converted into income.

The above analysis is not altered if *X* had not previously been taxed on the property donated to the son. If *X* obtained the property through a chain of gifts in which the original donor had been taxed on the property as income, the principle that someone in the chain of gifts should be permitted to consume the donated property without incurring an additional income tax would apply with equal force as when *X* himself was taxed on the income. If the donated property had appreciated in *X*'s hands (and so the appreciation had not been taxed to *X*), the donee will be taxed on that appreciation when it is realized and recognized, so there will be only one tax and one consumption. If *X* had inherited the donated property, which was not income in respect of a decedent, and if the property had been appreciated in the hands of the decedent from whom *X* inherited it, that appreciation will never be taxed to anyone because § 1014 of the Code provides *X* with a basis in the property equal to its value, typically determined at the time of the decedent's death.[99] Should the appreciated portion of the property for which *X* had obtained a stepped-up basis be taxed to the donee since there will be no double taxation of that portion of the donated property? The answer again is no. Section 1014 of the Code incorporates the policy that the appreciated portion of the inherited property would not be taxed to *X* as income if he sold or consumed the property. So, under Code § 1014, *X* is entitled to consume the inherited property or the proceeds from the sale of that property without incurring an income tax. If, instead of consuming it himself, *X* elects to enjoy vicariously the consumption of that property by someone of *X*'s choosing, that should not cause income taxation of the consumption any more than *X*'s personal consumption would have done so. Similarly, if all or a portion of the donated property were the product of tax-exempt income that *X* received (e.g., income from a state bond that is exempt from tax under § 103 of the Code), *X* should be permitted to have the income consumed by someone of his choice.

4. Choice Between Competing Principles

The determination of the correct tax treatment of gifts raises two competing tax principles or goals. One principle is that the individual who has been taxed on income should have a virtually unrestricted range of choices as to how that income will be used to purchase con-

99 I.R.C. § 1014 (2000).

sumption. The other principle is that an individual's taxable income should include all his receipts (other than a return of capital) so as to reflect accurately his ability to share the costs of government. It is not possible in the gift setting to adopt a tax rule that will comply with both principles. One must yield to the other. Congress chose to give priority to the principle of providing the taxpayer with a wider range of choices for consumption. A gift is excluded from a donee's income because of that commitment to the donor; the exclusion has nothing to do with the worthiness of the donee. Several commentators would prefer that priority be given to the principle of maximizing the accuracy of the measurement of a donee's ability to pay. While that is not an irrational choice, it is no more reasonable than the opposite choice that Congress made, and may well be less compelling. As discussed below, the congressional treatment of gifts comports with a concept of treating certain parties as a single tax unit for limited tax purposes.

Even some of the commentators who urge that gifts should be included in income, acknowledge that there are circumstances when they should not be or when some amount of them should not be. One example is that administrative expediency requires that minor items be excluded.[100] It would not be feasible to attempt to tax small everyday occurrences such as having friends over for dinner or making a wedding gift of modest value.

5. Support Payments

Payments in satisfaction of an obligation to support another are not gifts,[101] but their exclusion from income would seem desirable, albeit some commentators would impose limits on the amount excluded.[102] The satisfaction of a legal obligation of support, such as the payment of schooling expenses of a minor child, constitutes a consumption by the payor, and, even though the supported person benefits from that expenditure, only one income tax should be imposed. It is reasonable to treat the person obligated to provide the support and the object of that obligation as a single tax unit for purposes of the income tax. The local law's imposition on the payor of a legal obligation to pay for the support expenses of the beneficiary effectively treats the payor and the beneficiary as a single economic unit for that

100 *See* Kornhauser, *supra* note 5, at 36; *see also* SIMONS, *supra* note 5, at 135; Dodge, *supra* note 5, at 1192.

101 They are legally required payments and so are not motivated by detached and disinterested generosity, however much the payor may love the recipient. *See* Dodge, *supra* note 5, at 1202.

102 *See id.* at 1206–08.

purpose, and it is appropriate for the tax law likewise to treat those expenses as a consumption by a single taxable unit. Only one consumption took place, and so it is appropriate to impose only one income tax.

The tax law's treatment of alimony does not conflict with our view of how support should be treated. Prior to 1942, alimony payments were not income to the payee.[103] In 1942, shortly after the onset of World War II, Congress made alimony payments taxable to the payee and deductible by the payor;[104] and that scheme has continued to be the tax law's treatment of alimony.[105] The current tax treatment imposes only a single income tax on income used to pay alimony since the amount included in the payee's income is matched by the nonitemized deduction allowable to the payor.[106] The two provisions together (§§ 71 and 215 of the Code) constitute the means of implementing the income-splitting scheme that Congress has provided for divorced couples, and do not impose double taxation.

6. Single Tax Unit

Dodge acknowledges that transfers between spouses might be exempted on the ground that the two spouses make a single tax unit.[107] Without deciding the question, Klein notes that an immediate family might be regarded as a single tax unit for tax purposes so that transfers within the unit are of no tax significance.[108] But, there is no good reason to limit the single unit concept to spouses or members of an immediate family. The make-up of what constitutes a family has changed in recent years. Many people who are not married live together in a family-type setting.[109] The delineation of a single tax unit should not depend upon formal relationships, such as marriage and blood kinship. The current tax definition of gifts provides an excel-

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103 Gould v. Gould, 245 U.S. 151, 152 (1917); *see* Douglas v. Willcuts, 296 U.S. 1, 8 (1935) (explaining that alimony payments to a divorced wife are not considered income of the wife).

104 WILLIAM ANDREWS, BASIC FEDERAL INCOME TAXATION 130 (5th ed. 1999).

105 I.R.C. §§ 71, 215 (2000).

106 *Id.* §§ 62(a)(10), 71, 215.

107 *See* Dodge, *supra* note 5, at 1203. Simons seems to believe that some sort of accommodation should be made for certain gifts among family members, but he does not resolve just what that should be, and it probably would not be extensive. SIMONS, *supra* note 5, at 143 n.5.

108 Klein, *supra* note 5, at 253.

109 *See* Symposium, *Unmarried Partners and the Legacy of* Marvin v. Marvin, 76 NOTRE DAME L. REV. 1261 (2001) (including articles by Grace Ganz Blumberg, Margaret F. Brinig, David L. Chambers, Ira Mark Ellman, Ann Laquer Estin, J. Thomas Oldham, Milton C. Regan, Jr., and David Westfall).

lent standard for determining whether two people should be regarded as a single unit for certain tax purposes.

When a transferor makes a transfer to another out of "detached and disinterested generosity," the effect of current tax law is to treat the transferor and the transferee as members of a single tax unit for certain (but not for all) purposes. One member of the unit (the donor) will have been taxed on the income from which the donated property is derived, and the other member of the unit is permitted to use the donated property for consumption without incurring any income tax thereby. The separate identities of the parties are ignored for this very limited purpose. The delineation of the tax unit is made by looking to the intention of the transferor. If a donor makes a transfer out of detached and disinterested generosity, out of love and affection, the act itself demonstrates that the relationship between the donor and the donee is sufficiently meaningful to warrant regarding them as a single unit for certain limited tax purposes. The test rests on the nature of the relationship of the parties to each other as indicated by the transferor's action and intention rather than on some formal bonds. As already noted, since the donor previously paid the tax on the income that was given to the donee, it is appropriate to allow the donor to choose whose consumption will provide the donor with the vicarious enjoyment from which the donor will derive the most satisfaction; the single unit concept accomplishes that objective. This latter consideration is the justification for treating two persons as a single tax unit; the transferor's intent is the key to identifying the parties who should be so treated.

The single unit is defined by the intentions and wishes of the donor. We will explore later in this Article whether, in certain circumstances, the actions of a transferee should prevent the utilization of the single unit concept despite the donative intentions of the transferor.

Even if a donor barely knows the donee, but chooses to make the gift because the donee's consumption would provide the donor with optimum utility from the use of the property, the donor's choice should not be partially frustrated by taxing the donee. For example, *X* learns from a newspaper story that *Y*'s parents were killed by a terrorist attack, and that *Y* has financial needs as a consequence. *X*, who has never met *Y* or any of her family, is touched by her plight. *X* sends *Y* $2000 as a gift. The absence of a relationship between *X* and *Y* does not alter the facts that *X* desires to have his $2000 used by *Y*, and that *X* will derive more satisfaction from *Y*'s consumption than he would from using the $2000 for his own consumption. For a very limited tax purpose, *X* and *Y* should be considered a single tax unit so that only one income tax is imposed.

The single unit concept is reflected in the manner in which a donee's basis in donated property is determined. As noted previously, the general rule is that the basis that the donor had in the donated property immediately before the gift was made becomes the basis of the donee.[110] The limitation on the donee's basis for purposes of determining losses reflects an overriding concern of Congress not to permit one party to transfer a built-in loss to another. The general scheme though is one of a single tax unit—i.e., a single investment for the unit as a whole.

The single unit and single investment concept was adopted by the Supreme Court in its 1929 decision in *Taft v. Bowers*.[111] In that case, in connection with the determination of a donee's basis in stock acquired by gift and subsequently sold by the donee, the Court held that the statute establishing the transferred basis rule for gifts is constitutional.[112] The Court stated, "In truth the stock represented only a single investment of capital—that made by the donor. And when through sale or conversion the increase was separated therefrom, it became income from that investment in the hands of the recipient subject to taxation . . . ."[113]

Professor Kornhauser contends that single unit treatment is improper except for parties who are otherwise part of the same family unit for tax purposes. She states, "It is simply inequitable and inconsistent to treat [a donor and donee] as the same taxable unit for some tax purposes and not others."[114] She would limit the single unit treatment to gifts between spouses who file a joint return and between a parent and children under the age of fourteen.[115] Professor Zelenak agrees with Kornhauser on this issue and states that a single taxable unit "is not an absurd position, but with respect to all transferees other than spouses and children under age 14, it is fundamentally inconsistent with how taxable units are defined for other purposes—most importantly, for determining rates and exemptions."[116]

110 I.R.C. § 1015(a). The policy considerations for the addition to basis for gift taxes that were incurred is discussed later in this Article. *See infra* Part III.

111 278 U.S. 470, 482–84 (1929).

112 *Id.* at 484.

113 *Id.* at 482.

114 Kornhauser, *supra* note 5, at 36.

115 *Id.* at 36–37. The age of under fourteen was chosen because that is the age at which the "Kiddie Tax" causes a child's unearned (i.e., passive) income to be taxed at the parent's marginal rate. *See* I.R.C. § 1(g).

116 Zelenak, *supra* note 5, at 603.

Is it true that the treatment of persons as a single unit for some tax purposes and not for others is unique as to gifts? There are a number of stock attribution rules in the Code (§§ 267(c) and 318 are two examples) in which individuals and some fictional entities are treated as a single unit for certain limited tax purposes (for the purpose of treating each as owning the stock of another) but not for other tax purposes. Section 707(b)(3) of the Code provides attribution rules for partnership interests. The single tax unit concept is the underlying justification for the loss disallowance rules of §§ 267(a)(1) and 707(b)(1) of the Code. Zelenak does note that the stock attribution rules and loss disallowance rules "could be viewed as minor exceptions"[117] to the absence of a single unit approach in the tax law. Why are those provisions "minor" exceptions and apparently desirable ones, but the single unit concept for gifts a "major" exception and an undesirable one?

Moreover, those are not the only circumstances in which the tax law provides single unit treatment for some purposes and not for others. Even as to the tax rate applied to children under the age of fourteen, while their unearned (i.e., passive) income is taxed at their parent's marginal rate, their earned income is not and so the children and their parents are treated as a single tax unit for some tax rate purposes, but not for others. In addition, the entire scheme of Subchapter K of the Internal Revenue Code, dealing with the taxation of partnerships and partners, is laced with circumstances in which the partners are sometimes treated as separate individuals who have pooled their resources and are sometimes treated in the aggregate as a single entity.[118] The genius of Subchapter K is that Congress decided that it would not commit to one treatment, but would treat the partnership as an entity when the subject involved made that appropriate and treat the partnership as a collection of individuals when that was appropriate. Congress took to heart the admonition of Ralph Waldo Emerson that, "[a] foolish consistency is the hobgoblin of little minds."[119]

Indeed, the concept of a partnership as an entity is itself an example of a single unit. *A* and *B*, who are not related, form a service partnership in which they will divide the income equally between them. *A* brings in twice as much income as *B* does. The equal divi-

117 *Id.* at 603 n.15.

118 I.R.C. §§ 701–777.

119 RALPH WALDO EMERSON, ESSAYS, FIRST SERIES 57 (1865); *see also* William Allen White, *A Paste Jewel*, EMPORIA GAZETTE, Nov. 17, 1923, at 2 ("Consistency is a paste jewel that only cheap men cherish.").

sion of the profits shifts income that *A* earned to *B*. Under usual income tax rules, a diversion of income earned by one person to another would be disallowed, but the single tax unit treatment of the partnership overrides that rule. *A* and *B* are treated as a single unit for some tax purposes, but not for others.

The treatment of a donor and donee as a single tax unit for some limited tax purposes is not an extraordinary concept that departs from the normal tax scheme. It is merely one of a significant number of tax provisions that are grounded on the single unit concept.

Having rejected the single unit concept, Professor Kornhauser argues that the donor of appreciated property should realize and recognize a gain equal to the amount of appreciation.[120] While that is a plausible treatment, assuming that constitutional rules are not a barrier, as they appear not to be, the single unit concept points in another direction. Also, our position that the donor should be permitted to enjoy vicariously the consumption of the full amount of the accumulated income on which a tax has been paid would be partially frustrated if the gift were to accelerate the realization of appreciation of the donated asset.

Because the donor and donee retain their separate identities for other tax purposes, the transferred basis provision permits the donor to shift the tax incidence on appreciation of the asset to the donee. It seems likely that most gifts of appreciated property will be made to a donee who is in a lower income tax bracket than the donor, so that the transfer of the asset will result in a reduction of the tax levy on a sale of the asset. To prevent that from taking place, Congress could have provided that the donee's gain on a disposition of the donated asset would be taxed to the donor to the extent attributable to the appreciation at the time of the gift.[121] Alternatively, it could be taxed to the donee at the marginal tax rate at which it would have been taxed to the donor.[122] Apparently, Congress decided that the amount of revenue obtainable from protecting the progressive rates on the donated property was insufficient to justify undertaking the burden of

120 Kornhauser, *supra* note 5, at 37. In his recommendations for tax reform, Simons also urged that a donor be taxed on the amount of appreciation of donated property. HENRY C. SIMONS, FEDERAL TAX REFORM 44 (1950).

121 Compare I.R.C. § 704(c)(1)(B) for a similar approach that was adopted by Congress to deal with the circumstance in which appreciated property was contributed by one partner to a partnership which subsequently distributed the property to another partner.

122 This approach was adopted in the so-called "Kiddie Tax" provision. *Id.* § 1(g); *see* KAHN, *supra* note 10, at 705–11.

administering a regime of that nature, and so Congress has allowed the tax incidence to be shifted.

7. A Deduction for the Donor

Even if it is agreed that there should be a single income tax on donated property, that does not prove that the gift should be excluded from the donee's income. By excluding the gift from income, the incidence of the income tax is left with the donor who incurred that tax before making the gift. An alternative approach would be to shift the incidence of tax to the donee. That could be accomplished by including the gift in the donee's income, but allowing the donor a nonitemized tax deduction for the gift. While only a single income tax would then be imposed, the incidence would be on the donee. The reason for rejecting that approach is that it would greatly impair the goal of progressive taxation (i.e., the system of taxation under which tax rates rise as income increases). If the tax incidence were shifted to the donee, it would permit a high bracket taxpayer to shift income to a lower tax bracket donee. One might contend that the shifting of the incidence of tax to the donee does not distort progressivity because the incidence properly belongs on the donee. The problem with that view is that the availability of using gifts as a means of reducing the tax burden on income would be a powerful incentive to make gifts that otherwise would not take place. The potential for stimulating large gifts to low bracket donees would create a serious rupture in the progressive rate structure. The problem is similar to the one encountered when a donor transfers previously earned but untaxed income, and the courts fashioned the "anticipatory assignment of income" doctrine to prevent manipulation of the tax rate structure by that device.[123]

Although the basis transfer rules that now exist permit a shifting of the tax incidence on appreciation to a lower bracket donee, the extent of the injury to progressivity suffered thereby is of much less consequence than the injury that would be suffered if the tax law were to permit wholesale shifting of the tax incidence on all income, including personal service income. For administrative reasons, Congress is willing to allow a relatively small inroad into progressivity for the appreciated portion of donated property, but it is not willing to allow an expansive escape route for all earned income, especially since there is no administrative benefit from granting the donor a deduction. The denial of a deduction to the donor protects the integrity of

123 *See* KAHN, *supra* note 10, at 692–98.

the progressive rate structure. The shifting of tax incidence from the payor of alimony to the payee[124] has special purposes (such as relief from the added cost incurred when a single household is split into two households) that do not exist in the typical gift situation.

8. Gift Tax Imposition as Double Taxation

The making of a gift could cause the imposition of a gift tax. Does the possible imposition of a gift tax refute our contention that a taxpayer who has paid an income tax should be allowed to enjoy vicariously the consumption paid for by that income without incurring additional income tax costs and that Congress has chosen to implement that principle and the single unit concept? We do not believe that it does. In making tax rules, Congress often is faced with a need to choose among competing and irreconcilable principles or goals. In choosing between the principle of providing a taxpayer with great latitude in selecting the consumption to be purchased with accumulated income and the principle of obtaining an accurate measurement of a donee's ability to pay, Congress selected the former. The gift tax serves an entirely different set of goals.[125] We will not examine in this Article the several functions and goals of the gift tax. Suffice it to say that Congress determined that the functions and goals of the gift tax are more important than protecting the donor's choice of consumption, and Congress is willing therefore to impose a tax cost on the transfer of a large amount of property even though that can be seen as a reduction of the consumption available to the donee.[126] The fact that Congress gave priority to gift tax goals does not mean that Congress should give priority to other principles with which the single unit concept and the optimum utility of consumption goal come into

124 *See supra* notes 103–06 and accompanying text.

125 A major reason for having estate taxes is to reduce large concentrations of wealth. *See* DOUGLAS A. KAHN ET AL., FEDERAL TAXATION OF GIFTS, TRUSTS, AND ESTATES 9 (3d ed. 1997). Another reason, suggested by Professor Graetz is that transfer taxes add a measure of progressivity to the income tax by taxing wealth that may have escaped income taxation. Gift taxes serve two important functions. They complement estate taxes by imposing a cost on lifetime transfers so that death taxes cannot be completely avoided by that means. They also complement progressivity in the income tax by imposing a cost on transfers, which can result in the subsequent income from the transferred property being taxed to the donee at lower marginal tax rates. Michael J. Graetz, *To Praise the Estate Tax, Not To Bury It*, 93 YALE L.J. 259, 270–73 (1983).

126 Even when the donor pays the gift tax, as often is the case, it can be seen as a reduction of the amount available to the donee. The amount of the payment is lost to both parties. Were no gift tax imposed, that amount could have been added to the donee's gift.

conflict. Note that the gift tax applies only to gifts of large amounts and many gifts pass to donees without any gift tax being imposed.[127] The gift tax, therefore, does not impact the income tax treatment of gifts in most gift transactions.

II. THE MEANING OF THE TERM "GIFT" FOR GIFT EXCLUSION PURPOSES

The standard for determining whether a voluntary transfer without adequate consideration constitutes a gift is whether the donor had the requisite intention of "detached and disinterested generosity." But, just how detached and disinterested must the donor's intention be? Also, are there circumstances when the role or actions of the transferee should prevent gift treatment, regardless of the donor's intent? These questions, and others concerning the scope of the gift exclusion, come into sharp focus when examined in the context of the facts of the Ninth Circuit case of *Olk v. United States.*[128] We will first set forth the facts of the *Olk* case, both substantive and procedural, and then consider the scope of the term "gift" in the context of that case.

The taxpayer in *Olk* was a craps dealer in two Las Vegas gambling casinos.[129] Dealers were forbidden to fraternize with patrons of the casinos and were required to treat all patrons equally and show no preferences.[130] The monies used to make bets at the casinos were referred to as "tokes."[131] From time to time, some patrons would give tokes to the dealer or place a bet for him.[132] The tokes so received by a dealer were combined with the tokes received by other dealers, and the total was divided among them equally.[133] A dealer would be fired if he kept a toke rather than placing it in the common fund.[134] The management of the casino permitted this practice but did not en-

127 Putting aside the marital and charitable deductions, there is an annual exclusion for gifts of present interests to each donee. I.R.C. § 2503(b). At this writing the annual amount that can be excluded for each donee is $11,000, and, if spouses join together in the gift, the amount excluded is $22,000 per donee per year. Rev. Proc. 2001-59, § 3.19(1), 2001-52 I.R.B. 623; *see* I.R.C. § 2513. Also, amounts paid for education or medical care of an individual are exempt. *Id.* § 2503(e). In addition, subject to a dollar limitation, a unified credit insulates gifts not exempted by the exclusion from gift taxation. *Id.* § 2505. For gifts made at the time of this writing, the credit will insulate $1,000,000 from gift taxes. *Id.* § 2505(a)(1).

128 536 F.2d 876 (9th Cir. 1976).

129 *Id.* at 877.

130 *Id.*

131 *Id.*

132 *Id.*

133 *Id.*

134 *Id.*

courage it because tokes that the dealers received were taken out of the pool of money used to make bets.[135] No more than 5% to 10% of the patrons gave tokes to dealers.[136] The dealers performed no services for patrons that would be compensable.[137] Dealers anticipated receiving some amount of tokes, and their receipt was fairly regular and predictable.[138] The taxpayer averaged about $30 a day in such receipts.[139]

The taxpayer contended that the tokes he received were gifts and so were exempt from income tax.[140] The case was tried before a District Court,[141] which held for the taxpayer, and the Government appealed to the Ninth Circuit.[142] Two of the District Court's findings (numbered seventeen and eighteen) made the Government's task on appeal more difficult than the facts of the case otherwise would have suggested. Those two findings were,

> 17. The tokes are given to dealers as a result of impulsive generosity or superstition on the part of players, and not as a form of compensation for services.
> 18. Tokes are the result of detached and disinterested generosity on the part of a small number of patrons.[143]

The Ninth Circuit reversed the District Court and held that the tokes were taxable.[144] While the court reached the correct result, the court's discussion of the issues is questionable and presents a backdrop for examining the correct meaning of the term "gift."

The Ninth Circuit accepted the finding that the tokes were given out of "impulsive generosity or superstition on the part of the players."[145] The court then said,

> However our understanding also requires us to acknowledge that payments so motivated are not acts of "detached or disinterested generosity." Quite the opposite is true. Tributes to the gods of fortune which it is hoped will be returned bounteously soon can only be described as an "involved and intensely interested" act.[146]

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135 *Id.*
136 *Id.*
137 *Id.*
138 *Id.*
139 *Id.* at 876–77.
140 *Id.* at 878.
141 Olk v. United States, 388 F. Supp. 1108 (D. Nev. 1975), *rev'd*, 536 F.2d 876 (9th Cir. 1976).
142 *Olk*, 536 F.2d at 876.
143 *Id.* at 877.
144 *Id.* at 876.
145 *Id.* at 879.
146 *Id.*

This conclusion raises the question of the meaning of the "detached and disinterested" standard—just how detached and how disinterested must the transferor be?

One possible construction is that the terms are to be applied strictly so that a transferor can have no motives of a selfish or self-serving nature. That construction cannot be correct, because it would mean that there would be virtually no transfers that qualify as gifts, and Congress surely did not intend the statutory exclusion for gifts to have no meaningful consequence. The psychological make-up of human beings is complex. There often are mixed motives for making voluntary transfers. "Gifts" do provide benefits to a donor, even though no legal obligations are attached. The donor secures the gratitude and affection of the donee. Even if the donor gets no more than a smile and thanks, those are benefits. The gift may cause the donee to feel indebted to the donor to do something in return. A donee may be constrained to accede to the donor's wishes on matters arising subsequently because of the moral debt that the donee may feel he owes to the donor. To some extent, the gift empowers the donor with a kind of moral suasion over the donee. Of course, not every donee will feel a moral obligation or gratitude for receiving a gift.[147] But most will, and it is reasonable for a donor to anticipate that the donee will respond in that fashion. Should a donor's expectation of enhanced affection and obedience negate the classification of the transfer as a gift? There seems little doubt that the correct answer is no. If that were not true, only saints could make gifts, and probably few even of them. The test cannot require totally unselfish motives. It should be sufficient to require that the predominant motive be one that is unselfish. Moreover, the virtual impossibility of determining in most cases whether a donor had such expectations or cared a wit about them makes that construction infeasible to administer.

There is no limitation on the number of persons towards whom an individual can feel goodwill or affection. Obtaining the appreciation of a donee does not deprive society of any resource that otherwise would be available. In other words, no societal resource has been consumed. Nevertheless, such considerations are not devoid of relevance. The exclusion of gifts from income is grounded on permitting the donor to have the vicarious pleasure of having another consume the income on which the donor has been taxed. If the donor's primary motive is not to vicariously enjoy the donee's consumption, but rather is to purchase an attitude from the donee, then the condition

147 Two of King Lear's daughters are prominent examples.

that justifies granting an exclusion is not present. Even though there has been no consumption of a societal resource, gift treatment should be denied. As previously discussed, the gift exclusion rests on a balancing of two competing principles. In judging that balance, the principle of permitting a transferor a wide latitude to determine who will consume his income should be given little weight when the primary motive of the transferor is not for that purpose. However, as already discussed, gift treatment should be denied only where the primary motive of the donor is selfish. There will be very few circumstances in which that will be true.

To return to the facts of the *Olk* case, was the "impulsive generosity" of the patrons, which probably was the product of the euphoria of winning, any different from the disinterested generosity that the *Duberstein* test requires? The only difference seems to be that the district court's seventeenth finding indicates that the patrons' motives also had an element of a superstitious hope that the "gift" would induce the gods of chance to smile on their adventure. While the district court's finding is worded in the disjunctive, which might suggest that the court meant that some patrons were motivated by impulsive generosity and others by superstition, it seems clear that the finding does not have that meaning. If a patron wished to make a tribute to the gods, how does a transfer of tokes to a dealer accomplish that purpose? The transfer must have been at least partially motivated by a desire to enrich the dealer. No transfer was made exclusively for the purpose of placating the gods. Even where a patron did harbor a superstitious motive, the court did not find that it was the dominant motive. It seems far more likely that the tokes were given to the dealers primarily under the influence of the euphoria of the moment, and that a superstitious hope that the gift would win the favor of Lady Luck did not carry much weight. Consider the analogous motivations of a donor who makes a gift to a church. The issue there is whether the gift qualifies for a charitable deduction.[148] We will discuss later the extent to which a different definition of gift is warranted for charitable donations than the one used for the gift exclusion,[149] but in this context, the meanings should be similar. A donor may hope that his gift to the church will help pave the way for his ascension to heaven. He may hope that the gift will cause God to smile on his endeavors and bring prosperity and health to him and his family. Even if the donor harbors such feelings, they would not prevent the contribution

148 A deduction is allowed by I.R.C. § 170 for gifts to a qualified charitable organization. *See* I.R.C. § 170 (2000).

149 *See infra* Part IV.

to the church from qualifying as a gift. Motives of that nature are too insubstantial, and their presence too difficult to prove to be given any weight in determining a donor's dominant motive for making a gift. The patrons who gave tokes to the taxpayer in *Olk* are in essentially the same position in that respect.

The eighteenth finding of the district court—that the transfer of the tokes was the result of "detached and disinterested generosity"—would seem to have bound the court of appeals to affirm, unless it could legitimately conclude that the trial court had used an incorrect standard or that its finding was "clearly erroneous." Judge Sneed, who wrote the opinion in *Olk* and who is a prominent tax authority in his own right,[150] disregarded that eighteenth finding on the ground that it was an application of the *Duberstein*[151] standard to the facts of *Olk*, and therefore was a conclusion of law rather than a finding of fact, and so the "clearly erroneous" standard of review was inapplicable.[152] Judge Sneed's reasoning on this issue is contrary to Supreme Court holdings. In *Kaiser* and *Duberstein*, the Supreme Court held that a trial court's or jury's application of the "detached and disinterested generosity"[153] standard to the facts of a case is to be treated as a finding of fact and subject to the standard of review that applies to factual findings.[154] While the Supreme Court could have established a different standard of review, the one it chose is not unique for the review of "findings" of that nature. There are other examples of applying a "clearly erroneous" standard of review to a trial court's "finding," which consists of an application of a legal standard to a set of facts (sometimes called a mixed question of fact and law). A finding of negligence is a prime example. The determination that a defendant was negligent is an application of a legal standard to a set of facts, and the standard of review for that determination is the one applicable to factual findings.

Under the restrictive findings that the District Court made in *Olk*, it would not seem possible to find that the donors lacked the requisite intention for the tokes to be gifts. Why then did the court feel so strongly that the tokes were not gifts that Judge Sneed was willing to

150 2 WHO'S WHO IN AMERICA 2620 (44th ed. 1986–1987) (describing Judge Sneed, who was a prominent tax professor for many years and was Dean of Duke Law School).

151 Comm'r v. Duberstein, 363 U.S. 278 (1960).

152 Olk v. United States, 536 F.2d 876, 878–79 (9th Cir. 1976).

153 *Duberstein*, 363 U.S. at 285 (quoting Comm'r v. LoBue, 351 U.S. 243, 246 (1956)).

154 *See* United States v. Kaiser, 363 U.S. 299, 304–05 (1960); *Duberstein*, 363 U.S. at 290–91.

pronounce such questionable conclusions? The answer lies in the role that the taxpayer (the dealer) had in the scenario. Consider the following language from the opinion in *Olk*:

> Moreover, in applying the statute to the findings of fact, we are not permitted to ignore those findings which strongly suggest that tokes in the hands of the ultimate recipients are viewed as a receipt indistinguishable, except for erroneously anticipated tax differences, from wages. The regularity of the flow, the equal division of the receipts, and the daily amount received indicated that a dealer acting reasonably would come to regard such receipts as a form of compensation for his services. The manner in which a dealer may regard tokes is, of course, not the touchstone for determining whether the receipt is excludable from gross income. It is, however, a reasonable and relevant inference well-grounded in the findings of facts.[155]

At a minimum, the Ninth Circuit was greatly influenced in its decision by the role that the taxpayer (the transferee) had in the transaction. Indeed, it seems highly likely that it was the transferee's role, rather than the intention of the transferors, that led the court to hold that the tokes were taxable. It seems likely that the court refrained from stating its true reasons for its decision because it thought that the Supreme Court's decision in *Duberstein* precluded that approach. It also seems likely that the court expected the Supreme Court to review the *Olk* case and to modify its *Duberstein* rule.

The Ninth Circuit is not alone in believing that *Duberstein* established the transferor's intent as the exclusive test for gift treatment. But the Supreme Court's decision was made in a factual context in which no competing principles were invoked that might have led the Court to modify that test.[156] In a subsequent case presenting facts that do invoke a competing principle, a court could decide whether that competing principle carries sufficient weight to justify a modification of the *Duberstein* rule.

The better approach would be to recognize that there are circumstances where the role or actions of the transferee will prevent a transfer from qualifying as a gift, even though the transferor holds the requisite intention for a gift. This approach recognizes that the decision to exclude gifts rests on a balancing of competing principles, and the actions of a transferee in certain circumstances will enhance the weight to be accorded to what otherwise would be the subordinated

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155 *Olk*, 536 F.2d at 879.

156 *Duberstein*, 363 U.S. at 285, 286 (relying solely on the transferor's intent test for support).

principle. In short, there are certain circumstances where the focus should be on the transferee rather than on the transferor. The *Olk* case provides a good example of the type of situation in which the role of the transferee should control.

Consider some other examples. *X* fraudulently disguises himself to appear seriously handicapped and impoverished. Using that disguise, and sitting on a busy corner of a large city, *X* induces passersby to "give" him money, the total of which comes to a large sum. The people who gave *X* the money did so out of sympathy for his plight and out of detached and disinterested generosity. Nevertheless, the donations made to *X* are income to him. He obtained the donative intent of the transferors through fraudulent action, and he should not be allowed to obtain a tax benefit thereby. The fraudulent act of the transferee invokes another principle (the principle that a person should not be permitted to benefit from his own wrongdoing), and that principle overrides the considerations that underlie the provision for the exclusion of gifts. But that case is easy. Let us look at a more difficult one.

Y, who lost his legs in an accident some years ago, is a professional beggar. He occupies a space on a busy street in a large city and collects "donations" from passersby. *Y* makes no false representations, either explicitly or implicitly. *Y* succeeds in collecting a substantial amount of donations, and lives well from what he receives. The donations are made by persons who have the requisite donative intent for a gift. But *Y* is a professional donee. Should the gift exclusion be available to a person who derives a living from soliciting and receiving gifts from strangers? That is a difficult question. An adult individual who obtains a good living from receiving a monthly allowance from a parent does not have income from those gifts. The position of the professional beggar has many similarities to that of the adult child, but there is a meaningful difference in their circumstances in that the beggar solicits donations from strangers. In our view, and this is a close case, *Y* should be taxed on the donations. This is a case where the balancing of the two competing principles (the principle of maximizing the choice of consumption for the donor and the principle of accurately measuring each individual's ability to pay) may warrant a different outcome, because the latter principle carries more weight in this circumstance than it usually does. When a transferee makes a profession out of collecting gifts from strangers, the erosion to the proper measurement of income takes on greater significance than it has in the more typical gift situation, and the added weight thereby accorded to that principle seems to us sufficient to warrant taxing the donations.

We believe that the *Duberstein* rule should be revisited by the Supreme Court and modified to recognize that there are circumstances where it is proper for the action of the transferee to control the characterization of the transaction. It will be difficult to bring that issue to the Supreme Court unless one or more Courts of Appeals take that position so that the taxpayer will seek certiorari. It is unfortunate that the Ninth Circuit passed up that opportunity in the *Olk* case.

III. Adjustments to a Donee's Transferred Basis and Donor's Gain Recognition

A donor may incur expenses (such as title transfer costs) in connection with transferring property to a donee. One question is whether the amount paid by the donor for that purpose should be added to the basis that the donee acquires in the donated property. A second question is whether the donee's payment of those expenses will affect the donee's basis. Also, as previously noted,[157] in certain circumstances, typically only in the case of gifts of large value, the transfer may incur a gift tax. If the gift tax is paid by the donor, should that have an effect on the donee's basis? If the gift tax is paid by the donee, should that have an effect on the donee's basis and to what extent, if any, should it cause the donor to recognize income? We will address those questions in Part III of this Article.

A. *Transfer Expenses Other Than Gift Taxes*

The expenses incurred in transferring property to a donee, excluding gift tax impositions for the moment, do not represent an additional investment in the donated property. They are merely personal costs of shifting ownership from one party to another. As discussed above, we have concluded that one of the principles of the income tax system is to permit an individual who has paid an income tax to choose to have another person consume the taxed property without triggering a second income tax. That principle led to the exclusion of gifts from the donee's income to prevent a doubling of the income tax on a single consumption. But the same principle does not require that the personal expenses of transferring the property be treated as an investment. If the owner of an item of property held for personal use incurs a cost in moving the item to another location for personal reasons, that cost is not an investment in the property and does not increase the owner's basis. Similarly, the cost of moving the ownership of an item from a donor to a donee, who together comprise a

157 *See supra* note 49 and accompanying text.

single tax unit, does not constitute an investment. The expenses paid by the donor will not, and should not, affect the donee's basis.

If the donee pays the transfer costs, that is an expense of acquiring the property. But, as discussed in greater detail below,[158] in the case of a gift in which the donee makes a payment to the donor equal to part of the value of the transferred property, the donee's payment of partial consideration for the property affects the donee's basis only to the extent that the amount paid exceeds the donor's basis.[159] If the donor were primarily liable for the expenses that the donee paid, current tax law will treat the payments as consideration paid to the donor for receiving the property, which will affect the donee's basis only to the extent that the total of such consideration exceeds the donor's basis.[160] If the donor were not primarily liable for the expenses paid by the donee, regardless of whether the amount of the donee's payment exceeds the donor's basis, the payments should not affect the donee's basis because they do not represent an additional investment in the property and do not cause the donor to recognize income.

B. *Gift Taxes Paid by the Donor*

The donor is the party who is primarily liable for the payment of federal gift taxes.[161] The donor's payment of gift taxes could be treated the same as the payment of other costs of donating property, and thus have no effect on the donee's basis. Prior to 1958, the income tax law did not provide for any adjustment to the donee's basis because of federal gift tax payments, but the Code was amended in that year to provide an upward adjustment.[162] The justification for allowing an adjustment to the donee's basis is that the federal gift tax constitutes a double federal tax on the donated property—i.e., (1) the federal income tax previously paid by the donor (or by a previous donor of a chain of gifts) plus, if the property is appreciated, the federal income tax that will be payable by the donee when the donee sells the property, and (2) the federal gift tax on the transfer. As previously noted, Congress accepted this double tax consequence because the goals of the gift tax are deemed more important than the goal of allowing a taxpayer to enjoy someone else's consumption.[163] But the

158 *See infra* Part III.C.

159 *See* Treas. Reg. § 1.1015-4(a) (as amended in 1972); *see also infra* Part III.C.

160 *See* Treas. Reg. § 1.1015-4(a).

161 I.R.C. § 2502(c) (2000).

162 *See id.* § 1015(d); *see also supra* text accompanying note 50. Some states impose a gift tax, but there is no provision for increasing a donee's basis for state gift taxes.

163 *See supra* text accompanying notes 125–27.

double tax imposition made Congress uneasy, and so it enacted some relief in its 1958 amendment, providing for an addition to the basis of the donee. By increasing the donee's basis in the donated property, Congress mitigated the double tax by permitting the federal gift tax cost to reduce any gain the donee might have on a subsequent disposition of the property. It is by no means obvious that mitigation is desirable, but Congress has chosen to provide it. If the goals underlying gift taxation are deemed sufficiently important to justify double taxation, there seems to be no compelling reason to reduce the effective rate of the gift tax by mitigating it only in some circumstances. Even before the adoption in 1976 of a further limitation on the amount of increase to a donee's basis, there has been an arbitrary element to the operation of the provision in that the donee's basis is not permitted to exceed the fair market value of the property at the time of the gift.[164] The purpose of that limitation is to prevent the creation of a built-in loss deduction for the donee, but it means that there will be less, or no relief, from double taxation for donors who transfer property with a high basis in relation to its value. That discrimination was exacerbated in 1976 when Congress again amended the statute.

In 1976, Congress amended the Code to further limit the amount of gift tax that can be added to a donee's basis.[165] Section 1015(d)(6) of the Code limits the amount added to basis to the federal gift tax that is attributable to the appreciated portion of the donated property (i.e., the appreciated portion is the amount by which the value of the property exceeds the donor's basis).[166] In the *General Explanation of the Tax Reform Act of 1976* (prepared by the Staff of the Joint Committee on Taxation),[167] hereinafter referred to as the "*Blue Book*," the Joint Committee's staff stated that the congressional purpose in 1958 for providing an addition to the donee's basis was to insulate from income taxation a part of the appreciated portion of the donated property equal to the gift tax paid on the entire amount of appreciation.[168] In describing the reason that Congress decided in 1976 to amend the statute, the staff stated in the *Blue Book*,

164 I.R.C. § 1015(d)(1)(A).

165 *Id.* § 1015(d)(6).

166 The method for determining the amount of gift tax that is attributable to the appreciated portion of the donated property is set forth in Treas. Reg. § 1.1015-5(c) (as amended in 1995).

167 Staff of the Joint Comm. on Tax'n, 94th Cong., 2d Sess., General Explanation of the Tax Reform Act of 1976, at 561 (Comm. Print 1976), *reprinted in* 1976-3 C.B. (vol. 2) 573.

168 *Id.*

> Congress believed that prior law was too generous in that it permitted the basis of the gift property to be increased by the full amount of the gift tax paid on the gift and not just the gift tax attributable to the appreciation at the time of the gift. Consequently, the Act provides that the increase in basis of property acquired by gift is limited to the gift tax attributable to the net appreciation on the gift.[169]

Very little, if anything, can be said in favor of the 1976 amendment. The *Blue Book* states that Congress wished to mitigate the double taxation of the appreciated portion of the donated property, which will be subjected both to a gift tax and to an income tax when the property is sold. But the portion of the property equal to the donor's basis (i.e., the unappreciated portion of the property) typically will have already been taxed either to the donor or to a prior donor of a chain of gifts. If Congress shied away from a full-fledged double tax on the appreciated portion, why does it embrace a double tax on the unappreciated portion? It is true that if part of a donor's basis is attributable to a stepped-up basis obtained under Code § 1014 from an inheritance, that part of the donor's basis has not been subjected to an income tax, and so no relief from double taxation is warranted for the gift tax on that portion of the basis. But the administrative costs of ascertaining the amount of basis that can be traced to a Code § 1014 step-up is daunting. In our view, the aggregate amount of donors' bases that is attributable to a Code § 1014 step-up will not be great enough to justify either the administrative cost of identifying it or the adoption of a draconic rule denying an adjustment to the gift tax on the entirety of a donor's basis.

In our view, while the mitigation of a double tax (i.e., the imposition of both an income tax and a gift tax) is a defensible concept, it is not required by tax principles. However, having chosen that path, there is no principled reason to limit the mitigation to the double tax on the appreciated portion of the property.

C. *Gift Taxes Paid by the Donee*

As noted above, the donor is the party who has the primary liability for payment of the federal gift tax.[170] However, if the donor fails to pay the entire amount of the tax, the donee is secondarily liable as a transferee.[171] While the donor usually is the one actually to pay the gift tax, there are circumstances in which the donee pays all or part of

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169 *Id.*

170 I.R.C. § 2502(c).

171 *Id.* § 6901(a). The Government also has a lien on the donated property. *Id.* § 6324(b).

the tax. The donor may condition the gift on the donee's paying the gift tax, or the donor may fail to pay all of the tax so that the Government collects it from the donee or by enforcing its lien on the donated property.

If a gift is conditioned on the donee's payment of gift taxes, the donee's payment is treated as compensation to the donor, which reduces the value of the gift that is made and so reduces the amount of gift tax that is owed.[172] Because the amount of the gift tax depends upon the amount donated, the two figures are interdependent, which causes a calculation problem that, however, is resolved by use of an algebraic formula.[173] A donative transfer which is conditioned upon the donee's payment of the gift tax is sometimes referred to as a "net gift."[174]

Some states also impose a gift tax.[175] The party who has the primary liability for the payment of such taxes is set by state law; it may be placed on either the donor or the donee or on both jointly.[176] If a gift is made on condition that the donee pay a state gift tax liability for which the donor was primarily liable, the donee's payment of that gift tax is treated as compensation to the donor and reduces the value of the gift that was made.[177] In other words, a donee's payment of a state gift tax pursuant to a condition of the gift is treated the same, in this respect, as is a donee's payment of the federal gift tax, but only to the extent that the donor is primarily liable for payment of the state tax.[178] If the gift is conditioned on the donee's payment of both federal and state gift taxes, the computation of the amount given must take into account a reduction for both gift taxes.[179]

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172 *See* Rev. Rul. 81-223, 1981-2 C.B. 189; Rev. Rul. 75-72, 1975-1 C.B. 310.

173 *E.g.*, Rev. Rul. 75-72, 1975-1 C.B. 310.

174 *See* Diedrich v. Comm'r, 457 U.S. 191, 199 (1982).

175 For example, North Carolina and Wisconsin impose gift taxes. *See* Rev. Rul. 76-57, 1976-1 C.B. 297; Rev. Rul. 80-111, 1980-1 C.B. 208.

176 *Compare* Rev. Rul. 76-57, 1976-1 C.B. 297 (discussing taxation when North Carolina placed the primary liability on the donor), *with* Rev. Rul. 80-111, 1980-1 C.B. 208 (discussing taxation when Wisconsin placed the primary liability jointly on the donor and donee).

177 *E.g.*, Rev. Rul. 76-57, 1976-1 C.B. 297.

178 In Revenue Ruling 80-111, 1980-1 C.B. 208, a gift was made conditional on the donee's payment of the Wisconsin gift tax. Wisconsin law made the donor and donee jointly liable for payment of the state gift tax. Because only one-half of the Wisconsin gift tax was the primary obligation of the donor, only one-half of the gift tax paid by the donee constituted consideration to the donor and reduced the amount of the gift. *Id.*

179 Rev. Rul. 76-49, 1976-1 C.B. 294.

A net gift transaction is one in which the gift is either explicitly or implicitly conditioned on the donee's payment of the gift tax.[180] The rulings dealing with the effect of a donee's payment of the gift tax have all involved net gift situations and have expressly limited their holdings to situations where the gift was conditioned on the donee's payment of the tax.[181] What if a gift is not so conditioned, but the donee is required to pay the tax because the donor fails to do so? While the rulings do not address that situation, there is no reason for the donee's payment of the tax in such cases to be treated any differently. The donee's payment of the gift tax is as much compensation to the donor in such cases as it is where the payment is made pursuant to a condition of the gift. While, in such cases, the donor may have intended to make a larger gift, the donee's payment relieves the donor of an obligation, is compensation to the donor, and reduces the amount of the gift. It would be unrealistic to treat the donor's transfer and the donee's payments as independent gifts to each other rather than netting them out as a single transaction. The donee's payment is not voluntary; it is a condition imposed by law on the recipient of the gift; and so is integrally related to the donor's gift. Later in this Part, we will consider whether the current law's treatment of net gifts is warranted,[182] but given that treatment, a payment of gift taxes by the donee because of the donee's secondary liability should be treated the same.

If the gift was not conditioned on the donee's payment of the gift tax, will the donee have a right of reimbursement from the donor for having paid the tax or having the Government collect the tax through invoking its lien on the donated property? In our view, the donee will not have a right of reimbursement. A person who had expectations of receiving a gift which was not forthcoming can obtain restitution from a wrongdoer (or from a person who benefited from the wrongdoer's act) who unlawfully prevented the gift from being made. The right of reimbursement applies only against third parties, and does not apply against the donor or the donor's estate. Even as to a third party, there is no liability unless the same or another third party committed a wrongful act that prevented the gift from being made; the wrongful act must have been fraud, undue influence, duress, the use of physical force, or a similar unlawful act.[183] Moreover, even if such a wrongful

180 *See* Diedrich v. Comm'r, 457 U.S. 191, 199 (1982).

181 *See* Rev. Rul. 81-223, 1981-2 C.B. 189; Rev. Rul. 75-72, 1975-1 C.B. 310; *see also Diedrich*, 457 U.S. at 192.

182 *See infra* notes 201–07 and accompanying text.

183 *See* 4 GEORGE E. PALMER, THE LAW OF RESTITUTION § 19.5 (1978 & Supp. 2002).

act occurs, the donor's subsequent declaration that the donor no longer wishes to make a gift to the donee will defeat an action for restitution.[184] Clearly, there can be no action for restitution against the donor. In addition, in the case of a gift, the donor and the donee both benefit from the payment of the gift tax, and the Government's order of priority for collection does not mean that the donor was unjustly enriched by the donee's payment of the tax.

If, contrary to our view, the donee were held to have a right of reimbursement from the donor, the presence of that right would seem to prevent a reduction of the amount of the donor's gift for the gift tax liability and would prevent income recognition by the donor. But, what happens if the right of the donee is never enforced, as likely would be the case? When the statute of limitations for enforcing that right of reimbursement expires, there would be a cancellation of the donor's debt to the donee. For gift tax purposes, that cancellation should be treated as a reduction of the amount of gift that the donor made to the donee in the earlier year. The cancellation should be linked to the original gift and treated as a single transaction. Similarly, the transactional approach should be applied for income tax purposes as well, and so the donor should not recognize any income because of the cancellation. The cancellation should be treated as a reduction of the donor's gift for income tax purposes as well.[185] In any event, as noted above,[186] there likely is no right of reimbursement for the donee.

The Service's rulings on the treatment of a donee's payment of gift taxes related only to the gift tax consequence of those payments. The rulings cited above did not address the income tax consequences. Let us now consider the income tax consequences.

Because the donor is primarily liable for payment of the federal gift tax, the Supreme Court held in *Diedrich v. Commissioner* that the donee's payment constitutes an amount realized by the donor on the disposition of the property.[187] That conclusion accords with the gift tax treatment of such payments. We discuss the merits of that decision below, but since it does represent the current state of the tax law,

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184 *Id.*

185 *See* KAHN, *supra* note 10, at 70.

186 *See supra* notes 183–84 and accompanying text.

187 Diedrich v. Comm'r, 457 U.S. 191 (1982). A donee's payment of a state gift tax for which the donor was primarily liable will have the same income tax consequence as does the payment of the federal gift tax. *Id.* In *Diedrich,* the donee paid both federal and state gift taxes that were imposed on the transfer, and the Court treated the entire sum of gift tax payments as an amount realized by the donor. *Id.* at 192–93.

we will first consider the consequences of that treatment. The entire amount of federal gift tax paid by the donee is treated as an amount realized by the donor.[188] Because that amount (consisting of the gift tax on the value of the property) necessarily will be less than the value of the property, the transaction will be recast as a part-gift, part-sale transaction, which is one type of a bargain sale. If the amount realized by the donor (i.e., the gift tax paid by the donee) is greater than the donor's basis, the donor will recognize a gain to the extent of the difference. The entire amount of the donor's basis is offset against the amount realized in determining the donor's gain; the basis is not allocated between the part of the property that is sold and the part that is donated.[189] If the amount realized by the donor is less than the donor's basis, the donor nevertheless will not realize a loss even if the value of the property also is less than the donor's basis.[190]

The first step in determining the donee's basis in the donated property is to give the donee a basis equal to the greater of the donor's basis or the amount paid by the donee.[191] That figure is then increased by the amount of gift tax paid, even though paid by the donee, subject to the statutory limitations on the amount of increase in a donee's basis for gift tax payments.[192] Those limitations are that

188 *See id.* at 198–99; Treas. Reg. § 1.1001-1(e) (as amended in 1996).

189 *See Diedrich*, 457 U.S. at 198–99; Treas. Reg. § 1.1001-1(e). Initially, in a 1933 ruling, the Service maintained that, in the case of a bargain sale made for gift purposes, the transaction must be bifurcated into two separate transactions: a fraction of the property is treated as having been sold to the donee-purchaser for the amount realized by the donor-vendor, and the remaining fraction of the property is treated as a gift to the donee-purchaser. I.T. 2681, 12-1 C.B. 93 (1933). Under the 1933 ruling, the donor-vendor's basis in property that is the subject of a part-gift, part-sale treatment, must be apportioned between the portion of the property that is deemed to have been sold and the portion that was donated. *Id.* The donor-vendor's gain would then be measured by comparing the amount realized with the portion of the donor-vendor's basis that was allocated to the portion of the asset that was sold. The initial position of the Service is the better approach, but it is not the treatment that is currently accorded. In a 1939 Board of Tax Appeals (the prior name for the Tax Court) decision concerning a part-gift, part-sale transaction, the court held that the donor-vendor's entire basis in the asset is applied against the amount realized to determine the donor-vendor's gain, if any. Fincke v. Comm'r, 39 B.T.A. 510 (1939), *nonacq.*, 1939-1 C.B. 47, *withdrawn and acq.*, 1939-2 C.B. 12. The Service initially nonacquiesed in the *Fincke* decision; but, shortly afterwards, withdrew its nonacquiescence and substituted an acquiescence. Ever since, the Service has used the donor-vendor's entire basis in determining gain. This treatment is reflected in the Treasury Regulations, *e.g.*, Treas. Reg. § 1.1001-1(e) (1996), and has impliedly been accepted by Congress. *See* I.R.C. §§ 1011(b), 170(e)(2) (2000).

190 Treas. Reg. § 1.1001-1(e).

191 *Id.* § 1.1015-4(a)(1) (1972).

192 *Id.* § 1.1015-4(a)(2).

the basis cannot be increased to a figure that is greater than the property's fair market value and that only the gift tax on the appreciated portion of the property can be added to the donee's basis.[193]

The rule that provides the donee with a basis, before adjustments, equal to the greater of the donor's basis or the amount realized by the donor is appropriate.[194] The single unit concept treats the donor and the donee as one tax unit with a single investment in the property.[195] If the amount realized by the donor is not greater than his basis, the donor does not recognize any gain, and there has not been any additional investment in the property by the tax unit. All that has occurred is that some of the investment that the donor made has been returned to him and shifted to the donee, but the unit's investment has not changed. On the other hand, if the amount realized by the donor (i.e., the amount of gift tax paid by the donee) is greater than the donor's basis, then the donor will recognize income in the amount of the difference. The income is attributable to the donated property and will be characterized as gain from a sale of that property.[196] A portion of the appreciation of the property in the donor's hands has thereby been recognized. If the amount of that income recognition were not added to the property's basis, the gain that the donor recognized would be taxed a second time when the donee sells the property. It is necessary to increase the donee's basis by the amount of the donor's gain to prevent that doubling of the tax.[197] Providing the donee with a basis equal to the amount paid by the donee when that amount is greater than the donor's basis means that the donee's basis will equal the donor's basis plus the gain recognized by the donor.

It also is proper to apply the gift tax increase in basis when the donee pays the tax. Because current tax law treats the donee's payment as an amount realized by the donor, the transaction effectively is treated as if the donee paid consideration directly to the donor, and the donor paid the gift tax. The addition to donee's basis, therefore, should be the same as it would be if the donor had actually paid the gift tax. Even if the donee's payment of the gift tax were not treated as consideration to the donor, it is still appropriate to increase the donee's basis since that increase serves to mitigate the double taxation

193 I.R.C. §§ 1015(d)(1), (6).

194 Treas. Reg. § 1.1015-4(a)(1).

195 *See id.*

196 *Id.* § 1.1001-1(e)(1) (1996).

197 *See supra* notes 80–86 and accompanying text.

(of income and gift taxation) that the single tax unit of the donor and donee incurs.

Of course, only the gift tax attributable to the appreciated portion of the property is added to the donee's basis. But, in determining the portion of the property that gave rise to a gift tax, recall that the donor's basis is offset first against the amount realized by the donor. So, only the gift tax attributable to the amount of basis that is in excess of the amount realized will be disallowed as an addition to the donee's basis. If the amount realized equals or exceeds the donor's basis, then the entire amount of the gift tax paid by the donee will be attributable to the appreciated portion of the property, and that limitation will not be applicable.

While there is no authoritative declaration as to the correct method for determining a donee's basis in a net gift situation, the conclusions stated above are a reasonable application of the relevant tax rules. We believe that the rules are likely to be applied in that manner.

Finally, let us turn to a consideration of whether the Supreme Court reached the correct result in *Diedrich*.[198] There is no dispute that the decision reached in *Diedrich* is the law today,[199] but it is worthwhile to examine the merits of that rule.

Diedrich involved two consolidated cases in each of which a gift was made, the donee paid the federal gift tax, and the amount of that gift tax exceeded the donor's basis in the donated property. The Tax Court held that the donor did not recognize income from that transaction, and the Court of Appeals for the Eighth Circuit reversed. To resolve a conflict in the circuits on that issue, the Supreme Court granted certiorari. The Supreme Court held that, because the donor was primarily liable for the federal gift tax, the donee's payment of that tax satisfied a debt of the donor to the Government, and so was an amount realized by the donor on the disposition of the transferred property. The Court deemed it irrelevant that the donor's "debt" to the Government arose concurrently with the making of the gift and so was not a preexisting debt. The donor recognized gain to the extent that the gift tax payment by the donee exceeded the donor's basis.

198 Diedrich v. Comm'r, 457 U.S. 191 (1982).

199 Following *Diedrich*, Congress enacted § 1026 of the Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 494, so that the Supreme Court's decision would not be applied retroactively. Davis v. Comm'r, 746 F.2d 357 (6th Cir. 1984). Although "[C]ongress believed that taxpayers should not be adversely affected because they made gifts in reliance on what they believed was established law," the House Ways and Means Committee believed the decision in *Diedrich* was correct. *Cleaver v. Wis. Dep't of Revenue*, 447 N.W.2d 102, 104 & n.7 (Wis. Ct. App. 1989).

The key to the Court's decision was that the federal tax law makes the donor primarily liable for the gift tax (the donee is secondarily liable). The Court stated, "When a donor makes a gift to a donee, a 'debt' to the United States for the amount of the gift tax is incurred by the donor."[200] The holding of that case has been widely applauded by tax commentators,[201] but there is reason to question it.

In our view, much too much was made by the Court of the fact that the tax law places the primary obligation for the payment of the gift tax on the donor. The gift tax is a cost exacted by the Government for the transfer of donated property. The payment of that tax is as much for the benefit of the donee, who acquires the donated property thereby, as it is for the donor, who thereby places the property in the hands of the person he wishes to have it. In effect, the gift tax is a common obligation of both parties because its satisfaction is a necessary hurdle for the fulfillment of the transfer that both parties desire.

The statutory placement of the primary liability on the donor has little practical significance as to who will pay the tax since the donor can refuse to make the gift unless the donee agrees to the donor's proposal. The only meaningful significance of making the donor primarily liable is that, if the donor pays the tax, that payment will not constitute an additional gift to the donee. The fact that the gift tax paid by the donor is not included in the gifts made to the donee makes the gift tax scheme one that is "tax exclusive."[202] This is in contrast to the estate tax scheme in which the estate taxes paid to the Government are nevertheless included in the decedent's gross estate so that an estate tax is paid on the amount of estate tax itself.[203] The tax exclusive attribute of the gift tax is a major incentive for making lifetime gifts and thereby avoiding the tax inclusive treatment of the estate tax on the property that is donated. Congress's placing of the primary liability on the donor can be viewed as nothing more than the device that was chosen to implement the decision to make the gift tax a tax exclusive scheme in order to promote lifetime gifts. It hardly

200 *Diedrich*, 457 U.S. at 197.

201 *See* KLEIN ET. AL., *supra* note 47, at 198–99; Stuart Duhl & Jeffrey L. Kwall, *Supreme Court Holds That Net Gift Triggers Income to Donor: An Analysis of* Diedrich, 57 J. TAX'N 130 (1982); Renée T. Hennessy, Diedrich—*The Economic Reality of Net Gifts*, 13 TAX ADVISER 580 (1982); Dean J. Formanek, Comment, Diedrich v. Commissioner: *Closing the "Net Gift" Income Tax Loophole*, 68 IOWA L. REV. 379 (1983). *But see* Eric J. Thoman, Note, Recent Developments, *The Use of Net Gifts After* Diedrich v. Commissioner *Is Down but Not Out*, 61 OR. L. REV. 459 (1982) (criticizing the Eighth Circuit's decision in *Diedrich*).

202 *See* Karen C. Burke & Grayson M.P. McCouch, *Death Without Taxes*, 20 VA. TAX. REV. 499, 518 (2001).

203 *See id.*

seems appropriate to make significant income tax consequences turn on the happenstance that Congress chose one method to implement a tax exclusive scheme instead of some other method that would not have involved the placement of tax liability.

Moreover, in other areas of the income tax law, a liability that arises out of a matter of common concern to two parties has been treated as an obligation of both for purposes of the income tax law. Consider a circumstance that arises in connection with corporate reorganizations. In certain types of corporate reorganizations, no payment to the shareholders of a target corporation can be made in any form other than voting stock.[204] A payment to a target's shareholder in some form other than the acquiring corporation's voting stock is commonly referred to as "boot."[205] The use of any boot in such a transaction would prevent it from qualifying as a reorganization, thereby forfeiting all the favorable consequences that flow from that qualification. However, if the shareholders of the target corporation incur expenses that are directly related to the reorganization, such as legal and accounting fees, appraisal expenses, and registration fees, the acquiring corporation's payment or assumption of those liabilities does not constitute boot to the shareholders—i.e., it does not constitute consideration paid to the shareholders even though it is their legal liability that was satisfied.[206] The acquiring corporation's payment of such liabilities of the shareholders does not affect the qualification of the transaction for reorganization treatment.[207] Similarly, the income tax consequence of a donee's payment of a gift tax should not turn on the law's choice of where to place the primary liability for payment of the gift tax.

As to the question of whether, as a matter of tax policy, the donee's payment of a gift tax should reduce the amount of the donor's gift for gift tax purposes, our view is that it should not, regardless of whether the donee's payment was required by the terms of the gift. In other words, we believe that the revenue rulings to the contrary are bad tax policy although they are supported by the Supreme Court's decision in *Diedrich*.

204 The so-called "B" reorganization is an example of this rule. I.R.C. § 368(a)(1)(B) (2000). The same rule applies to the "C" reorganization, although there is some relaxation of the requirement in that case. *Id.* § 368(a)(1)(C).

205 KAREN C. BURKE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS 241 (4th ed. 1996); DOUGLAS A. KAHN & JEFFREY S. LEHMAN, CORPORATE INCOME TAXATION 616, 880 (5th ed. 2001).

206 *See* Rev. Rul. 73-54, 1973-1 C.B. 187 (citing cases).

207 *Id.*

Because we do not regard the donee's payment of the gift tax as compensation for the transfer, it should not reduce the amount of the donor's gift. The property transferred to the donee will no longer be part of the donor's estate when he dies; and so, unless part of the donor's transfer can be treated as a constructive reimbursement of the donee for the payment of the gift tax, and therefore effectively a payment of the gift tax by the donor (which constructive payment by the donor would qualify for tax exclusive treatment), the entire amount transferred should constitute a gift. In our view, the donor's transfer is not a constructive payment of the gift tax because it is paid by the donee for the donee's own benefit. Nevertheless, given the *Diedrich* decision, even though that is an income tax case, the current law is that the gift tax payment by the donee in a net gift transaction will reduce the amount of the donor's gift, and it seems likely that the same rule will apply when the gift tax is paid by the donee because of the donor's failure to pay the tax.

It is interesting to note what the tax consequences would be if, contrary to *Diedrich*, the donee's payment of the gift tax were not treated as consideration to the donor, and if contrary to our view, part of the donor's transfer were deemed to be a constructive payment of the gift tax. If that were the case, the amount of the gift would reflect a reduction for the gift tax payment. But if the property transferred was either appreciated or depreciated, the portion deemed to have been constructively used to pay the gift tax would cause the recognition of a gain or loss on that portion of the property. The constructive payment by the donor would constitute an exchange of the property. Note that, in such a case, unlike the current treatment of net gifts, the donor would be permitted to use only a portion of his basis in the property in measuring gain recognized, if any. If the donor recognized a loss on the constructive payment, it could be deducted regardless of the donor's relationship to the donee because the exchange would be made with the Government and not with the donee. In any event, none of that is relevant under current law, because the donee's payment will be treated as compensation to the donor.

IV. GIFTS TO A CHARITABLE ORGANIZATION

A. *Introduction*

Section 170(a) of the Code provides a deduction for a "charitable contribution." The Code defines a charitable contribution as a "contribution or gift" to an organization that qualifies as a charitable recipient.[208] Although the terms "contribution" and "gift" are not defined in § 170 of the Code or in the regulations thereunder, the courts have held that the two terms are synonymous.[209] For convenience, we will discuss solely the question of the meaning of the term "gift" for Code § 170 charitable contribution purposes because the same definition will apply also to the term "contribution."

Unlike the exclusion of gifts from a donee's income, no deduction was allowed for gifts to charitable institutions when the first post-Sixteenth Amendment income tax revenue act was adopted in 1913.[210] A provision allowing a deduction for charitable contributions by individuals was first included in the War Revenue Act of 1917.[211] The 1917 Act provided a deduction for

> [c]ontributions or gifts actually made within the year to corporations or associations organized and operated exclusively for religious, charitable, scientific, or educational purposes, or to societies for the prevention of cruelty to children or animals, no part of the net income of which inures to the benefit of any private stockholder or individual, to an amount not in excess of fifteen per centum of the taxpayer's taxable net income as computed without the benefit of this paragraph. Such contributions or gifts shall be allowable as deductions only if verified under rules and regulations prescribed by the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury.[212]

Corporations were not permitted a deduction for charitable contributions until 1935.[213] A deduction for charitable contributions and gifts by both individuals and corporations has remained in the Code, in one form or another, to the present day.

Unlike the Code § 102 definition of a gift, which became settled when the Supreme Court decided the *Duberstein*[214] case, many of the cases and rulings involving the definition of a gift for Code § 170 purposes are contradictory, and so the meaning of the term in the charitable gift area is not as neatly settled as in § 102. While there are numerous decisions on this issue, we will discuss four major tax cases

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208 I.R.C. § 170(c).

209 *E.g.*, DeJong v. Comm'r, 309 F.2d 373, 376 (9th Cir. 1962). Also, in *Hernandez v. Commissioner*, 490 U.S. 680 (1988), the Supreme Court noted with approval that courts have treated the two terms as synonymous.

210 *See* J.S. SEIDMAN, SEIDMAN'S LEGISLATIVE HISTORY OF FEDERAL INCOME TAX LAWS 1938–1861, at 945 (1938).

211 War Revenue Act, ch. 63, § 1201(2), 40 Stat. 300, 330 (1917).

212 *Id.*

213 Revenue Act of 1935, ch. 829, § 102(c), 49 Stat. 1014, 1016.

214 Comm'r v. Duberstein, 363 U.S. 278 (1960).

that illustrate the different constructions that have been given to the term.

B. DeJong v. Commissioner[215]

The DeJongs were a married couple who claimed a charitable contribution deduction for an amount paid to the Society For Christian Instruction.[216] The Society For Christian Instruction was a non-profit corporation that owned and operated a grammar and high school in the area where the DeJongs lived, and the DeJongs were members of the church associated with the school.[217] The school charged no tuition for its students but raised a majority of its funds by soliciting from parents of enrolled students.[218] During the year at issue, the DeJongs had two children enrolled in the school operated by the Society.[219] The sole issue for the Tax Court was whether the DeJongs could deduct $400, which was stipulated as the approximate cost for the Society of educating the DeJongs' two children.[220]

The Tax Court held that the disallowed $400 that the DeJongs "contributed" to the Society was in the nature of tuition paid for their children's education at the Society's school,[221] and the Ninth Circuit agreed.[222] The Ninth Circuit held that the standard set out in *Duberstein* in defining a gift for Code § 102 purposes applies equally to that term as used in Code § 170.[223] Thus, a charitable donor must have "detached and disinterested generosity" in order to qualify for the charitable gift deduction.[224] The Ninth Circuit held that because the $400 was given in exchange for taxpayers' children's education, it could not be a charitable gift as it was not given with the requisite state of mind.[225]

The Ninth Circuit in *DeJong* determined that the definition of gift for Code § 102 purposes should also be used for charitable contribu-

215 309 F.2d 373 (9th Cir. 1962).
216 *Id.* at 374.
217 *Id.*
218 *Id.* at 374–75.
219 *Id.* at 375.
220 *Id.* The DeJongs contributed $1075 to the Society, but the only issue before the Ninth Circuit was the $400 amount. The Service allowed the remaining portion of the DeJongs' contribution ($675) as a charitable deduction, and so there was no issue as to that amount. DeJong v. Comm'r, 36 T.C. 896, 897 (1961), *aff'd*, 309 F.2d 373 (9th Cir. 1962).
221 *DeJong*, 36 T.C. at 899.
222 DeJong v. Comm'r, 309 F.2d 373 (9th Cir. 1962).
223 *Id.* at 377 (citing Comm'r v. Duberstein, 363 U.S. 278 (1960)).
224 *Id.* at 378 (citing Comm'r v. LoBue, 351 U.S. 243, 246 (1956)).
225 *Id.* at 379.

tion purposes. In addition to the Ninth Circuit's decision in *DeJong*, a number of court decisions have applied the *Duberstein* definition of gift to the charitable contribution area.[226] But other courts have rejected the application of the *Duberstein* definition.[227] Indeed, the Ninth Circuit itself subsequently held that the *Duberstein* standard does not apply to charitable gifts made by a corporate donor.[228]

C. Singer Company v. United States[229]

In another significant case, the Court of Claims[230] specifically declined to utilize the *Duberstein* standard for the definition of gifts for purposes of the charitable gift deduction.[231] The Singer Company was a manufacturer of sewing machines.[232] During the year 1954, Singer sold a large number of machines to charitable organizations at break-even prices, which were far less than the retail value of the machines.[233] Some of the machines were sold to public and parochial schools, and some were sold to other charities, including churches, the Red Cross, hospitals, and government agencies.[234] Singer claimed a charitable deduction for the amount of the discounts that were given to the charitable organizations, and the Service denied those deductions.[235]

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226 *E.g.*, Winters v. Comm'r, 468 F.2d 778 (2d Cir. 1972); Sklar v. Comm'r, 2000 T.C.M. (RIA) ¶ 2000-118 (2000), *aff'd on a different standard*, 282 F.3d 610 (9th Cir. 2002); Fausner v. Comm'r, 55 T.C. 620 (1971); Wolfe v. Comm'r, 54 T.C. 1707 (1970).

227 *See* Crosby Valve & Gage Co. v. Comm'r, 380 F.2d 146, 147 (1st Cir. 1967); Singer Co. v. United States, 449 F.2d 413, 421–22 (Ct. Cl. 1971).

228 United States v. Transamerica Corp., 392 F.2d 522 (9th Cir. 1968), *aff'g* 254 F. Supp. 504 (N.D. Cal. 1966). While affirming the district court's decision denying the charitable deduction, the Ninth Circuit expressly rejected application of the *Duberstein* standard in deciding the deductibility of a corporate donor's contribution to a charity. *Id.* at 523–24.

229 449 F.2d 413 (Ct. Cl. 1971).

230 The Court of Claims was subsequently absorbed into the U.S. Court of Appeals for the Federal Circuit. *See* Federal Courts Improvement Act, Pub. L. No. 97-164, 96 Stat. 25 (1982).

231 *Singer*, 449 F.2d at 422.

232 *Id.* at 414.

233 *Id.* at 415–16.

234 *Id.*

235 Because Singer sold the machines for an amount that covered its basis and costs, the "contribution" to the charitable organizations was of a portion of the machines for which Singer had no basis. Had Singer sold those machines for their value, the amount received by Singer for the appreciated portion of a machine would have been treated as ordinary income to Singer. Under current law, a contribution to a charity is reduced for the portion of the value of the contribution that would have

The Service argued that the *Duberstein* definition should be applied.[236] The court chose to apply a different standard[237] and indicated its skepticism of the Service's position:

> [i]f we were to accept the definition of gift as it is proffered by [the Service], it would then be necessary for us to look to the subjective intent of the plaintiff when awarding discounts to organizations described by section 170(c). This would not be an impossible task, but it would indeed be a very difficult one. It would necessitate a determination of whether plaintiff gave the discounts because they were primarily motivated by business considerations or, conversely, because of "detached and disinterested generosity" and out of "affection, respect, admiration, charity or like impulses."[238]

Singer contested the subjective approach proposed by the Service and instead urged that a deduction for a gift should be denied only when "there is a specific and direct *quid pro quo* flowing from the transfer."[239] Singer's approach would take into account only direct benefits the transferor received and would ignore any indirect benefits.[240] The court rejected that distinction and instead made the test turn on the substantiality of the cumulative benefits the transferor obtained from the transaction.[241] While rejecting Singer's approach as "overly restrictive and quite narrow,"[242] the standard that the court chose is

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produced ordinary income if the property had been sold at its fair market value. I.R.C. § 170(e)(1)(A) (2000). If that provision had been in effect when Singer made the "contributions" in question, all or part of the contributions would have been disallowed as a deduction by that provision, except to the extent that some deduction may have been allowed by § 170(e)(3), which was added to the Code in 1976. *Id.* § 170(e)(3). But, the denial of a deduction for gifts of ordinary income property was added to the Code in 1962, and so did not apply to the contributions in the *Singer* case because they took place in 1954. *Id.* § 170(e). It is for that reason that there is no discussion of that issue in the case.

236 *Singer*, 449 F.2d at 418.

237 While the plaintiff in *Singer* is a corporation, and there are special considerations that militate against using the *Duberstein* definition for corporate charitable donors, *see* United States v. Transamerica Corp. 392 F.2d 522, 524 (9th Cir. 1968), *aff'g* 254 F. Supp. 504 (N.D. Cal. 1966), the court in *Singer* did not restrict its position to corporate donors.

238 *Singer*, 449 F.2d at 418–19 (quoting Comm'r v. Duberstein, 363 U.S. 278, 285 (1960)).

239 *Id.* at 419.

240 An example of an indirect financial benefit is a donation of land to a city for dedication as a public park that increases the market value of adjoining land that the taxpayer retains. Another example is Singer's donation of sewing machines to schools, which gave Singer the indirect benefit of creating a pool of potential customers.

241 *Id.* at 422–23.

242 *Id.* at 420.

closer to the one Singer sought than the one that the Service proposed.

The court found support for its holding in language of the committee reports to the adoption of the Internal Revenue Code of 1954 (which subsequently became the current Internal Revenue Code of 1986).[243] While there is very little legislative history to the original charitable deduction provision in 1917, a related provision, which was adopted in 1935, was included in the 1954 Code as § 162(b), and has remained in the Code relatively unchanged.[244] Section 162(b) of the Code disallows a business deduction for an item that would have qualified as a charitable contribution or gift if it were not for the limitations in Code § 170 on the amount that can be deducted.[245] When that provision was included in the 1954 Code, the committee reports discussed it and stated what the committees believed a charitable gift to be.[246] The committee reports on the inclusion of § 162(b) in the 1954 Code state that charitable gifts are "those contributions which are made with no expectation of a financial return commensurate with the amount of the gift."[247] It is noteworthy that in a subsequent case, the Supreme Court also quoted that language from the committee reports in passing on the meaning of the term gift in Code § 170.[248]

After discussing the legislative history to Code § 162(b), the court set out its definition for determining whether a payment will qualify as a gift:

> It is our opinion that if the benefits received. [sic] or expected to be received, are substantial, and meaning by that, benefits greater than those that inure to the general public from transfers for charitable purposes (which benefits are merely *incidental* to the transfer), then in such case we feel the transferor has received, or expects to receive, a *quid pro quo* sufficient to remove the transfer from the realm of deductibility under section 170. With this standard, we feel that the subjective approach of "disinterested generosity" need not be wrestled with and we are of the opinion that our approach coincides perfectly with our reading of section 162(b).[249]

243 *Id.*

244 *Id.* at 419–20.

245 Section 170(b) of the Code imposes a ceiling on the amount of charitable contributions that can be deducted, and that ceiling is framed as a percentage of income. I.R.C § 170(b) (2000).

246 *Singer*, 449 F.2d at 420.

247 *Id.* (emphasis omitted).

248 *See infra* note 292 and accompanying text.

249 *Singer*, 449 F.2d at 423.

The court then reached a divided result as to the deductions that Singer sought. As to the bargain sales of machines to schools, the court concluded that Singer received quid pro quo for those sales by facilitating the education of students to the use of sewing machines so that they would become customers and purchase sewing machines when they left school.[250] The court therefore denied Singer a deduction for the discount on the sales to schools.[251] However, as to the bargain sales of machines to other organizations, the court held that any benefits that Singer received were merely incidental.[252] The court therefore allowed Singer a deduction for the discount given to organizations other than the schools.[253]

D. United States v. American Bar Endowment[254]

The Supreme Court entered the Code § 170 controversy in 1986 with its decision in *United States v. American Bar Endowment.*[255] American Bar Endowment (hereinafter "the ABE") was a tax-exempt organization that, to help finance its charitable activities, raised money by providing group insurance, through regular insurance companies, to its members.[256] The ABE collected the premiums from the participants and remitted them to the insurers.[257] The ABE group plan had two advantages over purchases of individual insurance policies.[258] First, the size of the group provided bargaining power unavailable to individuals, and so the ABE could negotiate a lower premium.[259] Second, rather than basing the cost of the insurance exclusively on general actuarial tables, the cost of the insurance was based on the actual claims that the members made, and the group of the ABE members had favorable mortality and morbidity rates.[260] The actual premium that an insured was charged did not reflect the favorable experience

250 *Id.*

251 *Id.*

252 *Id.* at 424.

253 *Id.*

254 477 U.S. 105 (1986).

255 *Id.*

256 All members of the American Bar Association are automatically members of the American Bar Endowment. *Id.* at 107. The case involved two separate issues, but the charitable deduction issue is the one discussed herein. The other issue that the Court decided was that the income that the American Bar Endowment earned through the insurance offering program was "unrelated business income." *Id.* at 109–16.

257 *Id.* at 107.

258 *Id.*

259 *Id.*

260 *Id.*

of the group, but the insurer would refund the excess premium when experience showed the amount of overpayment.[261] The refund was labeled a "dividend."[262] When enrolling in the insurance program, the participants were required to waive any right to their portion of the dividend, and so the entire refund was returned to the ABE, which used the funds to finance its charitable operations.[263] Even though the individual insured members had no rights to their portion of the dividend, the ABE advised them that each individual's share of the returned overpayment constituted a tax-deductible gift to the ABE.[264]

The taxpayers in the charitable deduction portion of the case were four unrelated members of the ABE who had purchased insurance.[265] The Service denied a charitable contribution deduction to those individuals for the amount of their share of the dividend received by the ABE.[266]

The Supreme Court began by noting that "[a] payment of money generally cannot constitute a charitable contribution if the contributor expects a substantial benefit in return."[267] The Court implied that the receipt of only nominal benefits would not preclude a deduction.[268] Even when a taxpayer anticipates and receives a substantial benefit, the Court stated that the taxpayer can qualify for a deduction if the market value of the benefit received is outweighed by the value of the charitable gift. The Court referred to this type of gift as a "dual character" or "dual payment,"[269] that is, the gift has both a purchase element and a contribution element. The reader will recognize that the dual payment transaction is a version of the part-gift, part-sale transaction discussed earlier in this Article.[270]

The Supreme Court held that the proper test for determining whether a dual payment may qualify as a charitable gift was promul-

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261 *Id.* at 108.

262 *Id.*

263 *Id.*

264 If the insured members had been given a realistic option either to receive their portion of the dividend or to have it paid to a charity, those members who voluntarily elected to have their portion of the dividend paid to a charity would have qualified for a deduction. *See* Priv. Ltr. Rul. 2002-28-001 (Apr. 10, 2002). If that had been the case, those who elected to have the dividend paid to a charity would have donated property that they had an unrestricted right to receive. But that was not the situation that the Supreme Court faced in the *American Bar Endowment* case.

265 *Am. Bar Endowment*, 477 U.S. at 108–09.

266 *Id.*

267 *Id.* at 116.

268 *Id.* at 117.

269 *Id.*

270 *See supra* notes 188–90 and accompanying text.

gated by the Service in Revenue Ruling 67-246.[271] In that ruling, the Service established a two-pronged test for determining whether a dual payment is deductible. First, a contribution will be deductible only to the extent that it exceeds the market value of the benefits received in return. Second, the excess amount of contribution must have been made with the intention of making a gift—i.e., the taxpayer must have intended to contribute more than the benefit received.[272]

The Court noted that three of the four taxpayers in *American Bar Endowment* could not demonstrate that they could have purchased similar policies for a lower cost than the premiums paid and so the Court said that it must therefore assume that the value of the insurance purchased from ABE at least equaled the premiums paid by those three taxpayers.[273] The fourth taxpayer was able to show that he could have purchased the insurance for a smaller amount from a different group for which he was eligible, but because the taxpayer could not prove that he knew that to be true at the time that he purchased the insurance, the Court held that the fourth taxpayer did not have the requisite intention of making a gift—i.e., he could not show that he had deliberately overpaid for his insurance coverage.[274]

Thus, the Court adopted a two-prong test for determining whether a payment qualifies as a charitable gift. First, a taxpayer must transfer more to the charity then the taxpayer received.[275] This requirement says no more than that there must be a net contribution from the taxpayer or that no gift was made—an obvious point. Secondly, even if the taxpayer does give more than was received, the taxpayer must have done so knowingly; that is, the taxpayer must have had an intent to pass net value to the charitable organization.[276]

While the first prong of this test is mechanical, and thus appears easy to apply, the value of the benefit received will not always be measurable. In *American Bar Endowment*, the Court had to determine the value of an insurance policy;[277] that type of property, however, does not pose any difficulty of valuation. Insurance is a commercial service

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271 1967-2 C.B. 104.

272 *Id.* The Supreme Court noted that the Tax Court had adopted the two-pronged test, but the First Circuit had rejected the second prong of the test on account of the subjective nature of that prong. *See* Oppewal v. Comm'r, 468 F.2d 1000, 1002 (1st Cir. 1972) (adopting an objective test of value received).

273 *Am. Bar Endowment*, 477 U.S. at 118. As discussed below, it appears that the Court may have applied a subjective value test rather than using a market value. *See infra* notes 278–80 and accompanying text.

274 *Am. Bar Endowment*, 477 U.S. at 118.

275 *Id.* at 117.

276 *Id.*

277 *Id.* at 118.

for which an ample number of comparables are available on the market; thus, a strike price value can be determined. Even so, the Court appeared to apply a subjective approach. The Court stated,

> Three of the four individual respondents failed to demonstrate that they could have purchased similar policies for a lower cost, and we must therefore assume that the value of ABE's insurance *to those taxpayers* at least equals their premium payments. Had respondent Sherwood [the only taxpayer in the case that could show that he could have purchased insurance for less] known that he could purchase comparable insurance for less money, ABE's insurance would necessarily have declined in value to him. Because Sherwood did not have that knowledge, however, we again must assume that he valued ABE's insurance equivalently to those competing policies of which he was aware. Because those policies cost as much as or more than ABE's, Sherwood has failed to demonstrate that he intentionally gave away more than he received.[278]

There is some question as to the precise basis on which the Court made its decision. The emphasized portion of the quote suggests that the Court treated the subjective value that an insurance policy had to each taxpayer as representing the value of the benefit received by that taxpayer. While stating that each taxpayer needs the requisite subjective intention to make a charitable gift, the Court appears to have denied the deduction for three of the taxpayers because they did not pass any value, using a subjective test to determine value, as a donation to the ABE. It is possible, however, that the Court's decision concerning the first three taxpayers rests on a determination that, because they did not value the policies at a lesser amount than the premiums paid, they failed the second prong of the test in that they did not intentionally pass a net value to the ABE. Alternatively, despite the Court's reference in its opinion to "those taxpayers,"[279] the decision denying a deduction to the three taxpayers may have rested on the ground that they had the burden to show that the value of the insurance they received was less than the premiums they paid, and they were not able to satisfy that burden. Even though the opinion is worded subjectively, the Court could have meant nothing more than that the three taxpayers failed to meet their burden of proof to show that a net value passed to the ABE. However, the fourth taxpayer did show that he could have purchased insurance at a lower cost, and the Court appears to have treated that as a showing that the value of the insurance he received was less than the amount he paid to the ABE.[280]

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278 *Id.* (emphasis added).
279 *Id.*
280 *Id.* at 117–18.

Consequently, in order to deny the deduction, the Court needed to find that the fourth taxpayer failed to satisfy the second prong, and the Court did so. The Court's acceptance of a subjective valuation for the insurance policy that the fourth taxpayer acquired, as contrasted to a market valuation, suggests that the Court also used a subjective test to value the insurance policies acquired by the first three taxpayers.

If the Court truly meant to apply a subjective valuation approach to the first prong of the test, however, serious administrative problems arise. For example, a taxpayer makes a charitable gift and in return receives two tickets to a show. Should the amount of the charitable deduction depend on the subjective value that the taxpayer places on the right to attend that show? It is virtually impossible to administer a test based on the subjective value of the benefit to the taxpayer.[281] In this regard, it is noteworthy that the regulations to Code § 170 utilize an objective approach when valuing property in kind that a taxpayer contributes to a charitable organization.[282] Indeed, an objective approach to valuation is used throughout the tax law—for example, in calculating an estate or gift tax.[283] A subjective inquiry should apply only to the second prong of the test: did the taxpayer have the subjective intent to make a charitable gift? As the Supreme Court subsequently made explicit, the subjective inquiry for the second prong should focus exclusively on identifiable external facts.[284] However, as we shall discuss later, the objective valuation approach is not free from problems; valuation becomes highly speculative, at best, when dealing with goods or benefits that are not sold on a commercial market.[285]

281 For example, if a taxpayer who received theater tickets from a charitable donee has no interest in the show and discards the tickets, will his charitable deduction still be reduced by the market value of the tickets despite the taxpayer's having no use for them? The Service said yes. *See* Rev. Rul. 67-246, 1967-2 C.B. 104, 106 ("[T]he mere fact that tickets or other privileges are not utilized does not entitle the patron to any greater charitable contribution deduction than would otherwise be allowable.").

282 *See* Treas. Reg. §§ 1.170A-1(c)(1), (2) (as amended in 1996) (stating that the value of the property contributed shall be the "fair market value," which is determined as the price "at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts").

283 *See id.* § 25.2512-1 (as amended in 1992); *id.* § 20.2031-1(b) (as amended in 1965).

284 Hernandez v. Comm'r, 490 U.S. 680, 691 (1989).

285 *See infra* Part IV.E.

E. Hernandez v. Commissioner[286]

Only two years after deciding *American Bar Endowment,* the Supreme Court again addressed the issue of charitable deductions in a case involving charitable contribution payments made to the Church of Scientology.[287] The Church of Scientology provided "auditing" and "training" sessions for church members.[288] These sessions were meant to increase the spiritual awareness of its members.[289] The Church of Scientology kept a specific price list for these sessions, and price depended on a session's length and sophistication.[290] Members of the Church deducted those session payments as a charitable contribution under Code § 170, and the Service challenged the validity of the deductions.[291]

In a five-two decision, the Supreme Court stated,

> The legislative history of the "contribution or gift" limitation, though sparse, reveals that Congress intended to differentiate between unrequited payments to qualified recipients and payments made to such recipients in return for goods or services. Only the former were deemed deductible. The House and Senate Reports on the 1954 tax bill, for example, both define "gifts" as payments "made with no expectation of a financial return commensurate with the amount of the gift." S. Rep. No. 1622, 83d Cong., 2d Sess., 196 (1954); H. R. Rep. No. 1337, 83d Cong., 2d Sess., A44 (1954). Using payments to hospitals as an example, both Reports state that the gift characterization should not apply to "a payment by an individual to a hospital *in consideration of* a binding obligation to provide medical treatment for the individual's employees. It would apply

286 490 U.S. 680 (1989).

287 *Id.* at 683–84. For a detailed discussion of the background and lower court rulings involving *Hernandez,* see Jacob L. Todres, *Internal Revenue Code Section 170: Does the Receipt by a Donor of an Intangible Religious Benefit Reduce the Amount of the Charitable Contribution Deduction? Only the Lord Knows for Sure,* 64 TENN. L. REV. 91, 127–43 (1996).

288 As the Court described them, "audits" are one-on-one encounters between a participant and a church official (an "auditor") where the participant attempts to become aware of their own immortal spiritual being. Training sessions are courses where participants study the tenets of Scientology and seek to learn the knowledge necessary to become a church auditor. *Hernandez,* 490 U.S. at 684–85.

289 *Id.* at 685.

290 *Id.*

291 This rejection of the deduction should not have come as a surprise because the Service had made its position clear in Revenue Ruling 78-189, in which the Service explicitly prohibited a charitable contribution deduction for the costs of such Church of Scientology sessions. *See* Rev. Rul. 78-189, 1978-1 C.B. 68.

only if there were no expectation of any quid pro quo from the hospital."[292]

The Supreme Court noted that the Service, when determining whether there is any expectation of a quid pro quo, normally looks to the "external features" of a transaction.[293] The Court approved that approach because it "obviat[es] the need for the IRS to conduct imprecise inquiries into the motivations of individual taxpayers."[294] The Court stated that it had focused on external features in its recent decision in *American Bar Endowment*.[295] The Court disallowed the deduction because it held that the payments were given specifically in exchange for the audit and training sessions received by the members of the Church, i.e., it was a quid pro quo exchange.[296] The taxpayers, however, made no contention that their payment was a dual payment, part of which is deductible, and so the Court did not pass upon that issue.

The Court rejected the taxpayer's argument that a § 170 deduction should be allowed for a charitable gift if the only benefit that the taxpayer receives is a "religious" benefit.[297] The Court rejected that argument on the grounds that it had no support in the language of Code § 170, it might expand the realm of the charitable deduction beyond what Congress intended, and finally, that it would force the Service to differentiate religious and secular benefits.[298]

The dissent of Justice O'Connor makes some powerful arguments. One of her principal points was that it appears that the Service treated the Church of Scientology differently from any other religious organization where a payment was made for some religious benefit (such as pew rental or attendance at a synagogue on Jewish High Holy days).[299] Justice O'Connor noted that the Service denied a deduction in this case because it believed that the exchange was more of a consumption than a contribution. Justice O'Connor stated,

> It becomes impossible, however, to compute the "contribution" portion of a payment to a charity where what is received in return is not

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292 *Hernandez*, 490 U.S. at 690.

293 *Id.*

294 *Id.* at 690–91.

295 *Id.* at 691.

296 *Id.*

297 *Id.* at 693.

298 *Id.* at 692–93.

299 *Id.* at 707–09 (O'Connor, J., dissenting); *see also* Rev. Rul. 70-47, 1970-1 C.B. 49 (declaring pew rents and periodic dues to be deductible charitable contributions). This 1970 Ruling, however, was merely a restatement of the position the Service had taken since 1919. *See* A.R.M. 2, 1 C.B. 150 (1919).

> merely intangible, but an intangible (or, for that matter a tangible) that is not bought and sold except in donative contexts so that the only "market" price against which it can be evaluated is a market price that always includes donations. . . . Confronted with this difficulty, and with the constitutional necessity of not making irrational distinctions among taxpayers, and with the even higher standard of equality of treatment among *religions* that the First Amendment imposes, the Government has only two practicable options with regard to distinctively religious *quid pro quo:* to disregard them all, or to tax them all. Over the years it has chosen the former course.[300]

The dissent makes several valid points. When only a religious benefit is received, there is no commercial market for comparison to determine the dollar value of the benefit in order to compute the amount of overage that made up the contribution part of the dual payment. The valuation problem, however, may be obviated when the organization charges a specified price for the benefit. The Service could take the position that even if a portion of the payment is donative, the taxpayer has the burden of showing the amount of that portion; because the taxpayer cannot meet that burden, the Service could properly deny any deduction. Alternatively, the Service could allow the deduction on the grounds that charitable gifts should be construed liberally to carry out the congressional purpose of encouraging private funding of charitable activities. What the Service cannot do is to allow the deduction for some religious groups and deny it for others. The majority disregarded the inconsistent treatment issue because it was first raised on appeal, and so the majority determined that the record contained no facts from which the Court could appraise the validity of that contention.[301]

The majority responded to Justice O'Connor's point concerning the difficulty of valuing the receipt of benefits which are not traded on a commercial market by observing that, in such circumstances, as reflected in three courts' of appeals decisions,[302] the Service valued the benefits at the cost that the charity incurred in providing them.[303] The three decisions that the majority cited, however, do not support that assertion. On the contrary, the three courts' of appeals decisions that the majority cited dealt with the receipt of secular and religious education for the taxpayers' children at a school operated by a relig-

300 *Hernandez*, 490 U.S. at 706–07 (O'Connor, J., dissenting).

301 *Id.* at 702.

302 Oppewal v. Comm'r, 468 F.2d 1000 (1st Cir. 1972); Winters v. Comm'r, 468 F.2d 778 (2d Cir. 1972); DeJong v. Comm'r, 309 F.2d 373 (9th Cir. 1962).

303 *Hernandez*, 490 U.S. at 697–98.

ious organization.[304] The benefit that the taxpayers received (the education of their children) was a service regularly purchased on the commercial market, and therefore easily valued. The Service and the courts did value the taxpayers' benefit by looking to the cost incurred by the schools to educate the children, but neither the Service nor the courts were constrained to take that approach because of any difficulty in determining the market value of the education.[305]

Hernandez was a clear-cut victory for the Service. However, in 1993, after the denial of a deduction for payments to the Church of Scientology was challenged in the Eleventh Circuit on the ground of administrative inconsistency,[306] an issue which the Supreme Court had declined to address in *Hernandez*, the Service backed away from the *Hernandez* victory and, in a nonpublic agreement with the Church of Scientology, the Service agreed to allow members of the Church to deduct training and audit contributions.[307] In that same year, the Service declared obsolete its earlier Revenue Ruling 78-189,[308] which had stated that no charitable contribution would be allowed for payments to the Church of Scientology for auditing and similar services.[309] Thus, current tax law is in the awkward posture of the Service having effectively repudiated its own victory in obtaining a Supreme Court ruling and instead allowing deductions for what the Supreme Court held to be a quid pro quo exchange.

F. Recent Developments

In 1993, Congress stepped into the controversy. In the Omnibus Budget Reconciliation Act of 1993, Congress added new Code subsection 170(f)(8), which disallows any deduction for a contribution of

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304 *See Oppewal*, 468 F.2d at 1001; *Winters*, 468 F.2d at 780; *DeJong*, 309 F.2d at 374.

305 *See Oppewal*, 468 F.2d at 1002; *Winters*, 468 F.2d at 780–81; *DeJong*, 309 F.2d at 375.

306 Powell v. United States, 945 F.2d 374 (11th Cir. 1991) (holding that the claim of administrative inconsistency made a valid cause of action if factually established and concluding that the plaintiff had stated a claim upon which relief could be granted).

307 *See* Sklar v. Comm'r, 282 F.3d 610, 614 (9th Cir. 2002).

308 Rev. Rul. 78–189, 1978-1 C.B. 68.

309 Rev. Rul. 93–73, 1993-2 C.B. 75. The Service has explained the meaning of obsoleting a ruling as follows: "*Obsoleted* describes a previously published ruling that is not considered determinative with respect to future transactions. This term is most commonly used in a ruling that lists previously published rulings that are obsoleted because of changes in law or regulations." 1997-1 C.B. iv. For a discussion of whether Revenue Ruling 93-73 is valid, see Alison H. Eaton, Comment, *Can the IRS Overrule the Supreme Court?*, 45 EMORY L.J. 987 (1996) (arguing that Revenue Ruling 93-73 exceeded the IRS's authority and is invalid).

$250 or more "unless the taxpayer substantiates the contribution by a contemporaneous written acknowledgment of the contribution from the donee organization."[310] One requirement of the acknowledgment is that the donee organization must state if the organization provided any goods or services in exchange for the property received from the donor.[311] If goods or services were received, then the donee organization must give a "good faith estimate" of the value of those goods or services, or state that such goods or services consist solely of "intangible religious benefits."[312] The Code states that "the term 'intangible religious benefit' means any intangible religious benefit which is provided by an organization organized exclusively for religious purposes and which generally is not sold in a commercial transaction outside the donative context."[313] This language is closely related to that used by Justice O'Connor in her *Hernandez* dissent.[314]

It does not appear that the 1993 amendment overrules *Hernandez*. The legislative history to that amendment makes no mention of the *Hernandez* decision, and the Code itself addresses only substantiation requirements as contrasted to a substantive provision. Not only does the legislative history to the 1993 amendment not state that intangible religious benefits should be ignored,[315] the draft of the Senate Finance Committee's discussion of the Act states, "No inference is intended, however, whether or not any payment outside the scope of the *quid pro quo* disclosure proposal or substantiation proposal is deductible (in full or in part) under the present-law requirements of section 170."[316]

In the most recent case involving Code § 170, the Ninth Circuit, while not passing on the issue of charitable deductions in its holding,

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310 I.R.C. § 170(f)(8) (2000).

311 *Id.* § 170(f)(8)(B).

312 *Id.*

313 *Id.*

314 *See* Hernandez v. Comm'r, 490 U.S. 680, 706 (O'Connor, J., dissenting) ("It becomes impossible . . . . to compute the 'contribution' portion of a payment to a charity where what is received in return is not merely an intangible, but an intangible . . . that is not bought and sold except in donative contexts so that the only 'market' price against which it can be evaluated is a market price that always includes donations.").

315 Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13172(a), 107 Stat. 312, 455.

316 RESEARCH INSTITUTE OF AMERICA, OMNIBUS BUDGET RECONCILIATION ACT OF 1993 (S. 1134): TITLE VIII—FINANCE COMMITTEE REVENUE PROVISIONS AND EXCERPTS OF STATUTORY LANGUAGE FROM TITLES III AND VII, at 45 n.14 (1993); *see also* Todres, *supra* note 287, at 152 (asserting the 1993 amendment did not affect the result of *Hernandez*).

indicated its view in dictum that the substantive law of charitable gifts was not changed by the 1993 amendment, and that the ruling in *Hernandez* represented the current state of tax law on the subject.[317] In *Sklar v. Commissioner*,[318] the Sklars challenged the disallowance of their charitable contribution deduction for a portion of the tuition expense for their children to attend a religious school.[319] The Sklars attempted to deduct 55% of their tuition payment because that represented the proportion of the school day that was devoted to religious education.[320] First, the Sklars argued that this amount was deductible because religious education was an "intangible religious benefit," as that term was defined in the new Code § 170(f)(8).[321] Second, the Sklars argued that they should receive the deduction because the Service permitted a deduction for similar payments made by persons in the Church of Scientology who give a donation in return for an audit or training session.[322]

The Ninth Circuit denied the deduction. Citing *Hernandez*, the court stated that the Supreme Court specifically rejected the notion that there is an exception to the quid pro quo rule when a donor receives only religious benefits.[323] In dictum, the court noted that it seriously doubted that the Omnibus Budget Reconciliation Act of 1993 changed the definition of charitable contributions under Code § 170, or overruled the Supreme Court's decision in *Hernandez*.[324]

The court, applying the principles set out by the Supreme Court in *American Bar Endowment*, found that the Sklars failed to show that the payment to the school was a "dual payment."[325] The court held that the Sklars failed the first prong of the *American Bar Endowment* test. That is, the taxpayers could not show that the value of the secular education their children received was less than the donation given to the school.[326] As often occurs in other areas of the tax law,[327] there was a disagreement as to what type of education should be viewed as comparable to determine the market value of the secular education

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317 Sklar v. Comm'r, 282 F.3d 610 (9th Cir. 2002); *see* Eric Hildenbrand, *"No, You Still Can't Deduct that Payment to Your Child's Private Religious School": An Analysis of the Ninth Circuit Decision in* Sklar v. Commissioner, 55 TAX LAW. 995 (2002).

318 *Sklar*, 282 F.3d at 610.

319 *Id.* at 612.

320 *Id.*

321 *Id.*

322 *Id.*

323 *Id.* at 613.

324 *Id.*

325 *Id.* at 621.

326 *Id.*

327 *See, e.g.*, 26 U.S.C.A. § 482 (West 2002) (listing cases of disagreement).

received by the taxpayers' children. The Sklars argued that the comparison should be based on the cost of a public education, and thus the market value would be zero because public education is free. The court, however, held that the proper comparison is the tuition cost of a private school education, which has much higher tuition rates than the donation made by the Sklars.[328] The court allowed no deduction because the Sklars could not prove that they passed any net value to the school.[329] Because the court found that issue to be decisive, the court expressly refrained from passing on the issue of whether the 1993 procedural amendment to Code § 170 affected the substantive law on charitable gifts.[330]

G. *Current Status of Charitable Gifts and Analysis*

Despite a number of decisions to the contrary, it appears reasonably certain that the *Duberstein* standard of "detached and disinterested generosity" does not and should not apply to the determination of whether a transfer to a charity is a gift. Although the Tax Court has continued to utilize that standard,[331] and the Ninth Circuit initially utilized it in the *DeJong* case,[332] it has been rejected or ignored by the Supreme Court and by several Circuit Courts of Appeals. The First Circuit and the Court of Claims both rejected the *Duberstein* standard for charitable gifts.[333] In the two cases in which the Supreme Court passed on the definition of a charitable gift, *American Bar Endowment*[334] and *Hernandez*,[335] the Court made no mention of the *Duberstein* standard. Instead, the standard that the Court used was whether, and to what extent, the transferor received a financial benefit in re-

328 *Sklar*, 282 F.3d at 621.

329 *Id.* at 622. Because the court found that the donation was not a "dual payment," the court also stated that it did not have to rule on the Sklars' argument that the Service applies Code § 170 more favorably to members of the Church of Scientology than to members of other religions. *Id.* at 620. Interestingly, the court does suggest that if the Service were applying such a rule inconsistently, the court would find that the inconsistent treatment violates either the Code or the Establishment Clause of the Constitution, but it is unclear what remedy the court would apply. *See id.* at 614.

330 *Id.* at 610.

331 *E.g.*, Sklar v. Comm'r, 2000 T.C.M. (RIA) ¶ 2000-118, *aff'd*, 282 F.3d 610 (9th Cir. 2002); Fausner v. Comm'r, 55 T.C. 620 (1971).

332 *See* DeJong v. Comm'r, 309 F.2d 373 (9th Cir. 1962).

333 *See* Singer Co. v. United States, 449 F.2d 413 (Ct. Cl. 1971); Crosby Valve & Gage Co. v. Comm'r, 380 F.2d 146 (1st Cir. 1967).

334 United States v. Am. Bar Endowment, 477 U.S. 105 (1986).

335 Hernandez v. Comm'r, 490 U.S. 680 (1989).

turn for the "donation."[336] In other words, the Court employed a quid pro quo standard in which both direct and indirect benefits that the transferor obtained were taken into account.[337] The Ninth Circuit itself appears to have abandoned the *Duberstein* standard. First, in a 1968 decision, the Ninth Circuit held that the *Duberstein* standard does not apply when the charitable donor is a corporation.[338] Then, in its recent decision in *Sklar*, the Ninth Circuit did not mention the *Duberstein* standard even though the tax court, which the Ninth Circuit affirmed, had used it in making its decision in that case.[339] It is noteworthy that the cases in which the courts applied the *Duberstein* standard to deny a charitable deduction all involved circumstances in which the transferor received a substantial financial benefit or indirectly received one, and so the results in those cases would have been no different if the courts had applied a quid pro quo standard instead of the *Duberstein* standard.[340]

The *Duberstein* standard is inappropriate for charitable gifts, and the appellate courts' express or implied rejection of that standard was fully warranted. The exclusion of private gifts from a donee's income is based on the policy of permitting the donor to enjoy vicariously the consumption purchased with taxed income. Unless the transferor's purpose in making a transfer is to permit the transferee to use the funds, the circumstance for which the exclusion was designed does not exist, and so the transfer should be taxed. The "detached and disinterested generosity" standard is a useful test to determine whether the circumstances exist for which the exclusion was designed. The situation is quite different in the case of charitable gifts.

The charitable gift does not merely allow the taxpayer to transfer taxed income to another. The deduction allowed to the donor for charitable gifts means that the income that is transferred to the charity is not taxed to the donor or to anyone else. The congressional purpose for allowing the donor a deduction is to encourage the infu-

336 *See supra* notes 247–53 and accompanying text; *see also supra* notes 272–80.

337 Even the second prong of the *American Bar Endowment* test, which seemingly is a subjective inquiry into the intention of the donor, looks to objective factors to determine whether the donor intentionally passed net value to the charitable organization. *See Am. Bar Endowment*, 477 U.S. at 117–18.

338 United States v. Transamerica Corp., 392 F.2d 522, 524 (9th Cir. 1968).

339 *See* Sklar v. Comm'r, 282 F.3d 610 (9th Cir. 2002), *aff'g* 2000 T.C.M. (RIA) ¶ 2000-118.

340 *See* Winters v. Comm'r, 468 F.2d 778 (2d Cir. 1972); DeJong v. Comm'r, 309 F.2d 373 (9th Cir. 1962); Sklar v. Comm'r, 2000 T.C.M. (RIA) ¶ 2000-118 (2000), *aff'd on a different standard*, 282 F.3d 610 (9th Cir. 2002); Fausner v. Comm'r, 55 T.C. 620 (1971); Wolfe v. Comm'r, 54 T.C. 1707 (1970).

sion of private funds into the public sector.[341] The charitable functions that the donee organizations perform serve a governmental purpose, and many of those functions would have to be undertaken by the government if charities were not there to perform them.[342] Even if the charitable deduction is regarded as a type of government subsidy,[343] however, it serves to combine private and public funds to carry out quasi-governmental functions and thereby reduce the government's overall costs. While the private donor is able to channel the direction of the governmental funds to the functions that the charitable donee performs, that can be seen as beneficial in that it decentralizes the decisions as to some of the types of functions that are supported by tax revenues.

In any event, Congress has chosen to encourage charitable giving through the allowance of a tax deduction. Uncharitable motives for a donor's donation to a charity are irrelevant to the congressional purpose for granting the deduction; whereas, a selfish motive for a donor's transfer to a private party obviates the condition for which a gift exclusion is granted. For example, the fact that a donor's primary motive for making a charitable donation is to gain status in the eyes of the community would not affect the qualification of the transfer as a gift for which a deduction is allowable. The purpose for which Congress allows the deduction, i.e., to encourage the infusion of private funds into charitable operations, is not impaired by selfish motives of the donor in making the gift. Regardless of the donor's motivation, the charity obtains an increase in its net worth through the acquiring of the donation, and the donor receives no societal goods or services in exchange (or in the case of a dual payment, receives a lesser amount than was donated).

Further support for rejecting the *Duberstein* standard appears when the case of a corporate donor is considered. Corporations are

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341 The allowance of a charitable deduction can be justified for tax policy purposes on the ground that the donor will never consume the donated property, and so the income tax previously incurred for the acquisition of that property should be offset by allowing a deduction for the gift. *See* Kahn, *supra* note 3, at 15–16, 41–43. While that may be a valid policy justification, at least for many charitable gifts, the reason that Congress allows a charitable deduction is to encourage the dedication of private funds to public uses. This is reflected, for example, in the allowance of a deduction for the appreciated portion of donated capital gain property. *See* I.R.C. § 170(b)(1)(D)(ii) (2000).

342 While some charities perform functions that the government would not undertake, the deduction allowed for gifts to those charities is a cost or benefit (depending upon one's view of the function) of providing a decentralized system for deciding the types of functions that receive support.

343 *See* Kahn, *supra* note 3, at 41.

business organizations, and they operate for the purpose of producing income. Although some contend otherwise, it is unlikely that a corporation spends any of its funds out of "detached and disinterested generosity." There likely are some business purposes to the expenditure. Yet, Congress clearly intended corporations to qualify for a charitable deduction for making a donation to a charity. Code § 170(a)(2) permits a corporation to accrue a charitable deduction in certain circumstances, and Code § 170(b)(2) sets the limitations on the amount of a corporation's charitable gifts that can be deducted in a taxable year. Rather than permitting a corporation a business expense deduction, which is unrestricted as to amount, Congress chose to treat a corporation's donation as a charitable gift, which is subject to a dollar limitation.[344] The Ninth Circuit correctly refused to apply the *Duberstein* standard to a corporate donor.[345] The conclusion that *Duberstein* is not a correct standard for a corporate donor suggests that there should be another standard available that can apply equally well to corporate and individual donors, and that other standard should be employed instead of *Duberstein.* In other words, if Congress did not deem "detached and disinterested generosity" a requisite for corporate donors, it likely also did not deem that test to be a standard for noncorporate donors.

What, then, is the standard for determining whether a transfer to a charity is a gift? The standard rests on whether the transferor received a substantial benefit in return for, or as a consequence of, making the transfer. A benefit that accrues to the general public is not "substantial" for this purpose.[346] A substantial benefit will not deny the transferor a deduction to the extent that the amount transferred to the charity exceeds the value of the benefit obtained, provided that the donation of the excess value was intentional (i.e., a dual payment).[347] We will discuss dual payments later. First, let us focus on the types of benefits that can prevent charitable gift characterization.

Only benefits that have a financial dimension will be taken into account. The pleasure that a gift provides a donor, the spiritual experience that a donor may enjoy, and the enhanced personal status that a donor achieves in the community (although that could translate into an economic benefit) are not taken into account. Similarly, the benefits that the gift provides to a sizeable community, of which the

344 *See* I.R.C. § 162(b).

345 United States v. Transamerica Corp., 392 F.2d 522, 524 (9th Cir. 1968).

346 *See* Ottawa Silica Co. v. United States, 699 F.2d 1124, 1132 (Fed. Cir. 1983); Singer Co. v. United States, 449 F.2d 413, 423 (Ct. Cl. 1971).

347 *See* United States v. Am. Bar Endowment, 477 U.S. 105, 117 (1986).

donor is a member, are merely incidental to the donor and do not detract from the gift.[348] So, a gift to a theater company that permits the company to produce dramas that the donor can enjoy, along with other members of the public, does not constitute a receipt by the donor of a substantial benefit. Even if the donor obtained status from the gift that enabled the donor to serve on the theater's Board of Directors and participate in the selection of plays to be produced, that intangible benefit, whose financial value is difficult to measure, is not "substantial" within the meaning of the Code § 170 standard. If such benefits were required to be valued and reduce the amount of a charitable gift, the uncertainty as to the amount of allowable deduction that the valuation issue would engender, and the prospect of facing litigation over that issue, would chill a potential donor's enthusiasm for making a charitable contribution when such benefits might be present. If Congress wished to reduce a charitable gift for the receipt of benefits of that nature, as it did in the case of a contribution to a university for which the donor receives a right to purchase tickets to an athletic event,[349] Congress can establish an arbitrary figure or percentage of the donation to be disallowed. A statutory provision for a reduction of a specified amount or percentage eliminates uncertainty and is easy to administer. Congress chose that route in adopting Code § 170(*l*), and it can do so in other areas if it decides that a reduction is appropriate.

Several courts have stated that the benefit must be financial to be taken into account. The Supreme Court stated in *Hernandez* that gifts are "payments made with no expectation of a financial return commensurate with the amount of the gift."[350] The Court took that language from the Committee Reports to the 1954 Code.[351] But, *Hernandez* held that there is no exception to the quid pro quo rule for the receipt of a religious benefit, and the Court denied a deduction for a payment for spiritual instruction. The spiritual instruction that the taxpayers obtained in *Hernandez* might not seem to have been a

348 *See Singer*, 449 F.2d at 422–23. Of course, it seems obvious that if the community were limited to members of the donor's family, that would not deprive the benefit of substantiality.

349 *See* I.R.C. § 170(*l*).

350 *See supra* text accompanying note 292; *see also supra* text accompanying notes 242–47.

351 *See supra* text accompanying note 292; *see also supra* text accompanying notes 242–47.

financial benefit,[352] but the Court, nevertheless, had no difficulty concluding that substantial benefits existed that precluded gift treatment. There were financial benefits, however, in that the taxpayers obtained services that therefore were not available to others. In other words, the purchase of services by the taxpayers was a consumption by them of those services. The benefits were no less financial than is the purchase of personal services in the commercial market.

There is little reason to doubt that there is no per se exception for a religious benefit insofar as the courts are concerned. The Supreme Court's decision in *Hernandez* makes that clear. In administering Code § 170, however, the Service has treated many religious benefits as lacking substantiality. The private settlement that the Service executed with the Church of Scientology in 1993 is sui generis and should not be taken into account in determining the current state of the law. As the Ninth Circuit observed in *Sklar*, before the settlement, the Service had been "embroiled in an endless stream of litigation" with the Church of Scientology, and the Closing Agreement that the Service executed with the Church in 1993 was a kind of truce to stem the tide of that litigation.[353] Whatever constitutional issues that settlement might raise, it should not be determinative of the tax law's treatment of other benefits. However, apart from that settlement, the Service had ruled that pew rents were deductible[354] and has allowed deductions for payments for tickets to attend religious observances.[355]

The fact that there is not a per se exception for religious benefits does not mean that all religious benefits are substantial. It would be a mistake to lump all religious benefits into one category of being either "substantial" or "not." Each religious benefit, like any other benefit, should be examined individually to determine its substantiality.

Let us now consider what constitutes substantiality for this purpose. Unless de minimis, the acquisition of any property or services should be considered to be substantial. The transferor obtains the exclusive use of such property or services, and so the acquisition is either a consumption by the transferor or represents a future consumption. In *Hernandez*, the Court stated that Congress intended in Code § 170 "to differentiate between unrequited payments to qualified recipients and payments made to such recipients in exchange for

352 If an auditor receives compensation for providing those services (and we do not know if that is so), the training that taxpayers received to become auditors could have provided financial benefits.

353 Sklar v. Comm'r, 282 F.3d 610, 619 n.14 (9th Cir. 2002) (quoting Eaton, *supra* note 309, at 987–89).

354 Rev. Rul. 70-47, 1970-1 C.B. 49.

355 Hernandez v. Comm'r, 490 U.S. 680, 707 (1989) (O'Connor, J., dissenting).

goods or services"; and only the former are deductible.[356] In the absence of a countervailing tax policy, the renting of a pew therefore should not be deductible since it deprives the rest of society the use of that seat, and a payment made for the right to attend religious services, such as the service on a Jewish High Holy day, should not be deductible. However, there are tax policies that provide some justification for allowing a deduction when the benefits received are relatively small. We will discuss later the consequences if the payment made exceeds the value of the acquired property or service, and how such property rights or services are to be valued.[357]

It is not necessarily true that contributions for holy day services or pew rentals should be nondeductible. Attendance at a religious service is an ordinary occurrence in the affairs of a religious organization. If no price were specified for those services, and instead the members made voluntary contributions of varying amounts to the organization, the payments would not be treated as purchases of services other than the incidental benefits that are available to all members of the community. In *Oppewal, Winters,* and *DeJong* the courts of appeals treated a portion of the voluntary contributions that the taxpayers made to religious organizations as disguised payments of tuition for their children's education.[358] But, it is feasible to determine the value of a child's secular education because comparable services are purchased on the commercial market, and so the Service can assign a portion of the contribution to that cost. It is not feasible to determine the dollar value of attending a religious service because there is no commercial market for that service.[359] The Service could deny a deduction in that case on the ground that the taxpayer cannot meet the burden of proving the value of the benefit of obtaining access to what might be a scarce resource (for example, seats at a Jewish High Holy day service may be scarce). On the contrary, since Congress intended to encourage the private support of charitable organizations, the Service properly could decide to ignore the value of the attendance as de minimis, and allow the full amount of the payment as a deduction. The Service has chosen the latter course of action. The determination of whether to ignore such benefits or to treat them as substantial could turn on the relative size of the benefit obtained. Ignoring the

356 *Id.* at 690.

357 *See infra* text accompanying notes 361–64.

358 Oppewal v. Comm'r, 468 F.2d 1000, 1002 (1st Cir. 1972); Winters v. Comm'r, 468 F.2d 778, 781 (2d Cir. 1972); DeJong v. Comm'r, 309 F.2d 373, 379 (9th Cir. 1962).

359 *See Hernandez*, 490 U.S. at 707 (O'Connor, J., dissenting).

value of attending a religious service as de minimis does not require the Service to ignore the value of receiving an education.

The Supreme Court majority suggested in *Hernandez* that an alternative approach to dealing with the receipt of benefits that are not commercially marketed is to take as the benefit's value the cost that the charity incurred to provide that benefit.[360] The circumstances in which the Court noted that that approach had been taken by the Service all involved the valuation of children's education at a school operated by a religious organization.[361] Apart from the fact that it was not necessary to resort to a cost valuation in those cases, the cost of providing education can be determined and may bear some relationship to the value of the services received. But, that is not true for many religious benefits. How would you determine the cost of providing a seat at a religious ceremony? How would you determine the cost of celebrating a Mass or having a prayer recited for a deceased loved one? Even if you could determine the cost of providing such benefits, there is no reason to assume that those costs are commensurate with the value of the benefit that was conferred (i.e., the amount that a willing buyer would pay and at which a willing seller would sell). For example, a religious organization has its own doctrinal reasons for wishing to conduct rituals in a specified manner regardless of whether the cost of doing so exceeds the value of the services performed. A church may utilize volunteer teachers to provide Sunday School religious education so that the cost of providing the education may be far less than the value to the recipients. Cost is not a viable alternative for valuing the receipt of noncommercial benefits.

What if a religious organization charges a specified fee for a service or property? In that case, if one were to treat the price as having been set between arm's-length parties, under normal tax rules, the price itself would be deemed to be the value of the benefit that was acquired. If so, there would be no deduction for any part of the payment. The difficulty with that analysis is that the parties are not at arm's-length. The charitable organization presumably is an object of the purchaser's bounty, and so the purchaser may be willing to pay more for the benefit than its actual worth in order to contribute to the charity's operations. The difficulty of ascertaining the value of the benefit in such cases often will be insurmountable; in order to avoid that administrative burden, it is reasonable to treat the value of the benefit as being equal to the price that the charity charged for it. While that position has a small element of arbitrariness about it; it is a

360 *See id.* at 697–98.

361 *See supra* notes 300–01 and accompanying text.

practical solution, and if it were adopted, organizations likely would structure their fee schedules accordingly. Moreover, that solution is supported by the principle that the taxpayer has the burden of establishing the value of the benefits received, which, in such cases, the taxpayer is unable to do or to prove that the price paid is excessive.

For example, if a religious organization has a Sunday School for children of its members, and if the organization charges a specified fee for the religious education obtained at the Sunday School, none of that payment should be deductible. Perhaps, the congressional purpose for allowing a deduction might justify a construction under which the designation of a specified fee would be ignored, but that would seem to be an excessively liberal extension of the statutory language. Moreover, there is a problem with treating the child's religious education as something isolated from secular education. The Sunday School training could include historical material and language training, for example, in Hebrew, Greek, or Latin. There is no reason to treat a fee paid to a religious organization for such education any differently from a fee paid to a secular organization for such education. Also, for constitutional reasons, the Service and the courts would be loathe to embark on an attempt to distinguish the secular educational elements from the religious ones.

The treatment of the receipt of religious benefits is still unresolved. When they are substantial in value, such as the receipt of educational benefits, they likely will prevent a deduction, except for the peculiar circumstance of the Closing Agreement with the Church of Scientology. If they are small in value, and if no specified price is set for them, the Service will ignore them as de minimis—i.e., as not being substantial—and there is a reasonable likelihood that the courts would sustain the Service if the issue were litigated. Even if a specified price is set, the Service has allowed a deduction when the benefit is part of the ordinary functions of the religious organization, such as attendance at a religious service. This treatment may be justified on the basis that the price is not set between persons at arm's-length, and the value of the benefit is relatively small.

If the taxpayer receives a substantial indirect benefit from a payment to a charitable organization, that will be taken into account.[362] But the indirect benefit does not reduce the net value that the charitable donee received, so why should that reduce or eliminate the amount of deduction the donor receives? For example, if *X* donates land to an educational organization which builds a school on the land, and the presence of the school enhances the value of land that

362 *See* Singer Co. v. United States, 449 F.2d 413 (Ct. Cl. 1971).

X owns for sale in that area, then *X* has received an indirect benefit from making the contribution.[363] The Federal Circuit denied *X* a deduction in that circumstance.[364] Because the educational organization got the full value of *X*'s contribution, the question arises as to why a deduction should be disallowed to *X*. The answer is that charitable deductions are allowed only to the extent that the donor's wealth is reduced. The statutory deduction for charitable gifts is for the purpose of aiding charitable functions, but it also serves to recognize that the dedication of the donor's funds for a charitable purpose is not a consumption by the donor. Because the donor paid tax on the donated funds and will not obtain the consumption to which that tax payment entitles the donor, the deduction effectively retroactively insulates from tax the income that was the source of the contribution. But, to the extent that a donor is compensated for a "donation," that amount is still available for consumption; it would be a windfall to allow the donor a deduction to that extent.

Dual payments are deductible only to the extent that the amount contributed exceeds the value of the amount of benefit that the donor obtained from the contribution, and only if the excess contribution was intentional. There is no reason to deprive a donor of a deduction merely because he receives partial consideration. If the benefit received is not one that is purchased on the commercial market, valuation may not be feasible; and the alternative of using the charity's cost as the value may not be practical or realistic. In such cases, if the benefit received is relatively small in comparison to the amount contributed, it should not be treated as substantial and should be ignored. If the benefit received is significant in comparison with the contribution made, it should not be ignored; because the taxpayer has the burden of proving the amount by which the donation exceeds the value of the benefit, the taxpayer will not be able to satisfy that burden, and no deduction should be allowed.

Congress may deal with this issue in certain circumstances by drawing a line and allowing a deduction of a specified amount or percentage of a contribution. A contribution to a university's athletic department may entitle the contributor to purchase tickets to athletic events at the market price, when tickets otherwise would not be available to the donor. The value of the right to purchase those tickets is difficult to determine. The tickets may be worth more than the price at which the university sells them. If tickets are not available, the price charged by scalpers may be the actual value of the tickets, and so the

363 *See* Ottawa Silica Co. v. United States, 699 F.2d 1124, 1132 (Fed. Cir. 1983).
364 *Id.*

value of the donor's benefit may be the difference between the face price of the tickets and the price that the scalpers charge. But scalpers typically sell tickets shortly before the athletic event takes place, and so the value of tickets at the time that the contribution is made may be unclear. Valuation may be even more difficult if tickets to the event are available to the general public, but the contribution entitles the donor to purchase tickets for especially desirable seats which are not generally available. Congress addressed this problem by adopting Code § 170(*l*). That provision authorizes a donor who makes a contribution to a college or university that entitles the donor to purchase tickets for an athletic event to deduct 80% of the contribution.[365] Congress drew an arbitrary line and disallowed 20% of the contribution as representing the value of the benefit that the donor obtained.

If a benefit for which a valuation is not feasible is purchased from a charitable organization at a specified price, the price could be deemed to be the value of the benefit because it was set by the charity in an arm's-length transaction. As previously noted, the difficulty with that treatment is that the parties are not really at arm's-length because the charity is an object of the purchaser's bounty, and so the purchaser may be motivated to pay more than the benefits' value. In the absence of a congressional resolution, such as the adoption of Code § 170(*l*) to permit a deduction of a percentage of a contribution to a school's athletic department, it seems reasonable, as a matter of administrative convenience, to treat the specified price as the value of the property unless the benefit is small and is an element of the celebratory function of the religion.

Let us return to the question of the proper treatment of a donation to a charitable organization by a parent of a child attending a private school operated by that organization. For the moment, to remove the religious issues from the question, let us have the school be one that is operated by an educational organization that is not affiliated with a religion. Let us assume that the organization charges a tuition for attendance which, while a substantial figure, is insufficient to pay for the cost of the child's attendance. If the school has an endowment, some of the shortfall can be made up through income from the endowment. Let us assume that the school has no endowment, or has one that does not provide sufficient funds to make up the shortfall. The school discloses this circumstance to the parents of its students and urges them to consider making a contribution to the school to meet its shortfall and to provide the means of improving its offerings. Parents are not required to make a contribution; the

365 I.R.C. § 170(*l*) (2000).

child's right to attend the school will not be affected by a parent's failure to make a contribution. Some parents contribute enough to cover the shortfall for their child, some contribute more, some contribute less, and some make no contribution. Contributions are also made by persons who have no children in attendance and have no prospects of having a child attend. The circumstance described is one that exists for many private secondary schools and for many colleges and universities. The contributors who are not parents can deduct the entirety of their contributions. The question is whether the contributing parents should be denied a deduction for the shortfall attributable to their child's attendance?

In our view, the answer to that question should be no. The contributing parents are paying the tuition that the school charged and are not required to pay more. For practical reasons, it is appropriate to treat the value received by the contributing parent to be equal to the price charged. It does not appear to be relevant that the price paid is less than the full cost of providing the services to the child because the parent is under no obligation, legally or by custom, to pay a greater amount. It is not unusual for tuition to be less than the cost of providing the education. It is true for both public and private schools. If the tuition set is reasonable, as determined by comparison with the tuition for similar schools, the price set by the parties should be treated as determinative. We know of no circumstance in which the Service has challenged a deduction for a parent in such a case, although that does not mean that they could not do so at a future date.

If one or more of the circumstances described above are altered, our view of the proper tax treatment might change. For example, if a child's right to attend would be affected by a failure to contribute, or if there is substantial pressure on a parent to contribute at least enough to pay the shortfall, which pressure could arise from disclosures of contributions that would embarrass the parent in the community if it is customary for parents who can afford it to make such contributions, that would mean that at least a portion of a parent's contribution was not entirely voluntary. If the only persons who make contributions are the parents, and if most of the amounts of the contribution relate to the shortfall, that would strongly suggest that the "contributions" are actually disguised tuition payments.

What if the school makes no charge at all for tuition and obtains its needed funds exclusively from contributions, mostly from the parents? That was the situation in *DeJong*. By not making a stated charge, the parties forfeited the contention that the price charged for the service and accepted by the parent should be treated as the value of the service. In our view, the government then is obliged to value the service received by the contributing parent and treat the transaction as a dual payment in which the amount contributed is reduced by the value of the service received. The result should be the same even if contributions are also made by persons who are not parents. If a small charge is made for tuition that is not comparable to charges made by similar educational organizations, the contribution still should be treated as a dual payment. The tax treatment should not be obviated by the device of making a token charge for the service. While there is an element of arbitrariness in distinguishing the cases where no tuition is charged and those where a substantial but insufficient charge is made, it is an identifiable line to draw and has the doctrinal virtue of treating the price paid for tuition the same as one made at arm's-length. Concededly, the line is harder to defend if a school were to charge a reasonable fee for tuition and then provide all or virtually all of its students with a full tuition scholarship. Unless the plan is a subterfuge, we would allow a deduction for the parents' contributions, even in that case.

There is no reason that the treatment of contributions by a parent of a student attending a private school operated by a religious organization should be treated differently from the treatment described above.

CONCLUSION

The principal ground on which the gift exclusion has been disputed is that it does not provide an accurate measure of the donee's capacity to consume and so under-represents the base figure for determining the donee's proper share of the nation's tax burden. Our response to that argument is that there is a competing tax principle to permit a taxpayer to choose either to use taxed income for the taxpayer's personal consumption or to enjoy vicariously the use of that income by another for the other's personal consumption. These two principles must be weighed against each other because it is not possible to accommodate both of them. On balance, in the typical gift situation, the principle of allowing the donor to vicariously enjoy the consumption purchased by another with the income on which the donor had paid income tax is weightier than the income measurement principle, or at the very least is in equilibrium with that principle, and so the decision to exclude gifts from income does not constitute a departure from an ideal tax structure. On the contrary, the congressional decision to exclude gifts is appropriate, and so the administrative and judicial application of that exclusion should not strive for a cramped construction of what constitutes a gift.

If the transfer of a gift were itself deemed a consumption by the donor, the donor would thereby have obtained the consumption to which the payment of an income tax entitled him. If that were true, the case for taxing the gift to the donee would be powerful. On the contrary, we contend that the transfer of the gift is not a consumption by the donor. No societal resource is captured by making a gift. A gift merely transfers the power to consume a societal resource from one person to another. The psychic benefits a donor enjoys from making the gift not only is not a consumption by the donor; it is the enjoyment of that benefit that is the *raison d'etre* for excluding gifts from income—i.e., to permit the donor the vicarious enjoyment of having his income used by a person of his choice. The policy on which the gift exclusion is based is that a person who pays income tax thereby becomes entitled to have that income used to consume a societal resource, and the taxpayer should be given a wide range of choices as to how and by whom that consumption will be enjoyed.

By bringing to light the foundation of the gift exclusion as a balancing of competing principles, that understanding becomes a lens through which transactions can be examined to properly classify them as gifts or not. An illustration of the usefulness of that lens is the question it raises as to whether, under certain conditions, factors other than the transferor's intent should be taken into account in making a gift classification. For example, it can help to determine whether donations to a professional beggar constitutes a nontaxable gift. It also helps in determining whether the term "gift" should have a different meaning in other income tax areas such as the deduction allowed for charitable contributions.

The *Duberstein* standard of "detached and disinterested generosity" that is used to determine whether a transfer is a "gift" for purposes of the gift exclusion provision is not an appropriate standard for determining charitable gifts. While the tax court has continued to apply the *Duberstein* standard to charitable gifts, more recent appellate court decisions, including the Supreme Court, have not used that standard. Instead, the appellate courts have applied a requirement that, to qualify as a charitable gift, the transferor must not have derived, directly or indirectly, a substantial benefit as a consequence of making the transfer to the charity. If the transferor did derive a substantial benefit from making the transfer, a deduction will nevertheless be allowed to the extent that the transferor intentionally transferred a greater amount to the charity than the value of the benefit obtained thereby (a dual transfer).

It is not entirely settled as to what types of benefits will be treated as substantial. We contend that only benefits of a financial nature should be taken into account, and it appears that the courts generally follow that view. There is an open question as to the treatment to be accorded to a receipt from a religious organization of a purely religious benefit. The Supreme Court has held that benefits are not to be excluded merely because of their religious nature. In administering the provision for a deduction, however, the Service has permitted a donor to deduct the entire amount of a donation without any reduction for the receipt of a religious benefit that is not of a type that is traded on a commercial market. It is appropriate to allow that deduction if the charity does not set a fee of a specified amount for the benefit. The question becomes more difficult, however, if the charity does establish a specified amount as the fee for the benefit. If the benefit is a basic element of ordinary religious observance, such as attendance at a religious service, there is a strong case for allowing the deduction, and the Service has done so. If the benefit is peripheral to religious observance, and if the size of the benefit is substantial, the issue becomes murky. In our view, no deduction should be allowed in such cases.

The court decisions dealing with a child's education at a school that provides both religious and secular education have denied any deduction for amounts of contributions deemed attributable to that education. If a child were to receive exclusively religious education, we conclude that a fee for that education ought not to be deductible. However, the only authority on that question is the Supreme Court's *Hernandez* decision, which denied a deduction for the fees paid for the religious education of adult members of the Church of Scientology. While the Service subsequently agreed to permit deductions for such fee payments by members of the Church of Scientology, notwithstanding the contrary decision of the Supreme Court, that concession was made to bring to a close a long history of multiple litigation between the Service and that church, which had culminated in a challenge by the Church to the denial of the deduction on the ground that the Service permitted deductions for analogous fees paid by members of other religious organizations. Rather than continue to litigate those issues, the Service sought to end the dispute. Regardless of the merits of that decision, it should not be taken as an indicator as to how the charitable deduction statute will be construed in other situations.