

**August 2011 Student Update Memorandum for**

**Miller & Maine's**

**The Fundamentals of Federal Taxation:  
Problems and Materials  
(2d ed. 2010)**

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## **Chapter 1: Introduction**

**Page 7: In Part C.2 (“Treasury Regulations”), insert the following material at the end of the first paragraph:**

In *Mayo Foundation for Medical Education & Research v. United States*, 131 S. Ct. 704 (2011), the Supreme Court clarified the level of deference that courts should grant treasury regulations when faced with an ambiguous Code provision. Specifically, courts will apply the approach in *Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984), and, thus will defer to a treasury regulation if it reasonably resolves a statutory ambiguity. *Chevron* deference will apply to all treasury regulations, whether issued pursuant to the general grant of authority or pursuant to a specific congressional grant of authority, as described above.

## **Chapter 2: Gross Income**

**Page 14: In Part A.3 (“Long-Standing Administrative Practices”), insert the following after the first sentence:**

For example, the IRS has a longstanding policy of excluding from income most government benefits and assistance payments. *See* Rev. Rul. 75-271, 1975-2 C.B. 23 (stating “disbursements from a general welfare fund in the interest of the general welfare are not includible in gross income”). In some cases, however, Congress chooses to override this administrative fiat and tax such benefits. *See* IRC §§ 85 (unemployment compensation), 86 (social security payments).

## **Chapter 3: Gifts and Inheritances**

**Page 47: After the first paragraph add:**

In December of 2010 Congress reinstated section 1014 for years 2011 and beyond. For more details see new Chapter 40 in this supplement.

## **Chapter 5: Discharge of Indebtedness**

**Page 67: Add the following sentence at the end of the last bullet:**

This provision does not apply to discharges that occur after 2010.

## **Chapter 9: Depreciation and Amortization**

**Page 123: In section III.B, Bonus Depreciation, 1. Section 179: substitute the following for the second and third paragraphs:**

There are limits on the amount that can be expensed in any given year. For tax years beginning in 2011, the maximum allowable deduction for all qualifying property placed in service is \$500,000. IRC § 179(b)(1). The \$500,000 amount is reduced dollar-for-dollar (but not below zero) by the amount by which the cost of qualifying property placed in service during the tax year exceeds \$2,000,000. IRC § 179(b)(2). Thus, if we buy \$2,500,000 of section 179 property in 2011, we get no section 179 deduction. Congress changes the section 179 dollar and investment limitations quite often on a temporary basis. For example, for tax years beginning in 2012, the section 179 maximum deduction is set at \$125,000 and the phase-out starts at \$500,000 (with both amounts adjusted for inflation). IRC § 179(b)(1), (2), (6). For tax years beginning after 2012, the section 179 maximum deduction will be reduced to \$25,000 and the phase-out will start at \$200,000, absent further congressional tinkering. IRC § 179(b)(1) & (2).

Note the amount eligible to be expensed cannot exceed the taxable income derived by the taxpayer from the active conduct of any trade or business, with any disallowed deductions due to this limitation permitted to be carried forward. IRC § 179(b)(3). Note also that the section 179 deduction applies ahead of the deductions authorized under section 168 and, as a result of the “not chargeable to a capital account” language, reduces basis just as they do.

**Example.** In 2011, Taxpayer purchases section 179 property (depreciable tangible personal property for use in business) costing \$2,100,000. Taxpayer may elect to expense up to \$500,000 of the cost of the property, subject to the limitations imposed under section 179(b). Under section 179(b)(2), the \$500,000 amount is reduced dollar-for-dollar by the amount by which the cost of the property exceeds \$2,000,000. Thus, the amount eligible to be expensed is only \$400,000. [This amount cannot exceed taxable income. IRC § 179(b)(3).] Basis is reduced by the expensed amount of \$400,000, before applying regular depreciation rules (i.e., the double declining balance method) to the \$1,700,000 remaining basis. If Taxpayer buys \$2,500,000 of section 179 property in 2011, he would get no section 179 deduction because of the dollar and investment limitations.]

**Page 124: In Section B.2 (“Section 168(k)”)**, replace the first paragraph with the following:

To further stimulate the economy, Congress has occasionally enacted a temporary provision that provides an extra, up-front depreciation deduction for qualified property (i.e., new, depreciable tangible personal property). For the years 2008 through 2012 (through 2013 in the case of property with a longer production period and certain noncommercial aircraft), section 168(k) authorizes a taxpayer to deduct 50 percent of the cost of qualified property as depreciation in the year of acquisition. [Note that the bonus depreciation rate is increased from 50 percent to 100 percent in the case of qualifying property acquired after September 8, 2010, and before January 1, 2012 (or before January 1, 2013, in the case of property with a longer production period and certain noncommercial aircraft).] This deduction is computed after applying section 179 (if it was elected) and before the regular depreciation deduction is calculated for the year. Thus, the adjusted basis used for section 168(k) purposes is the cost basis minus the section 179 deduction. The basis reduction resulting from the section 168(k) deduction then further reduces the amount of basis available for the regular section 168(a) deduction. Although the extra depreciation deduction is scheduled to expire for purchases beginning in 2013 (2014 in the case of property

with a longer production period and certain noncommercial aircraft), the provision has been reenacted several times and thus may be extended.

## **Chapter 11: Other Personal Expenses**

**Page 154: In Section A (“Qualified Residence Interest”), insert the following after the citation to the first sentence of the first paragraph:**

*See Rev. Rul. 2010-25, 2010-44 I.R.B. 571 (ruling that indebtedness in excess of \$1 million that a taxpayer incurs to acquire, construct, or substantially improve a qualified residence may constitute home equity indebtedness).*

**Page 154: In Section B (“State and Local Taxes”), replace the second sentence with the following:**

Through 2012, taxpayers have the option of deducting state and local sales taxes instead of state and local income taxes. IRC § 164(b)(5).

**Page 156: In section E. Medical Expenses, at the end of the first paragraph add:**

The Tax Court has recently ruled that the medical expense deduction is applicable to some costs arising from sex reassignment surgery. *See O’Donnabhain v. Commissioner, 134 T.C. No. 4 (2010).*

**Page 156: In section E. Medical Expenses, after the second paragraph add:**

Pursuant to the health care reform law enacted in March 2010, for tax years beginning after December 31, 2012 the threshold for deducting medical expenses increases to 10 percent of adjusted gross income. This parallels the treatment of such expenses under the alternative minimum tax. *See IRC § 56(b)(1)(B).*

**Page 160: In Related Matters, the second bullet (“Education Expense Deductions”) should be amended by replacing the last two sentences with the following:**

The above-the-line deduction for qualified tuition and related expenses, which expired at the end of 2009, was extended for two years. The deduction is now slated to expire at the end of 2011. However, Congress has extended the life of this provision on more than one occasion and it may do so again.

**Page 161: Add the following after the bullet on Health Savings Accounts:**

Section 36B, enacted as part of health care reform in March 2010, created a Health Coverage Tax Credit (HCTC). The HCTC is a refundable credit equal to 80% of the costs of certain health care insurance of qualified low income individuals. The provision is effective for tax years after December 31, 2013.

**Chapter 12:**  
**The Deduction Hierarchy: Adjusted Gross Income, Taxable Income, the Standard Deduction, and the Personal Exemptions**

**Page 165: In Part A (“Itemized Deductions Versus the Standard Deduction”), insert the following note at the end of the first paragraph:**

[Note: In 2011, the standard deduction, adjusted for inflation, is \$11,600 for a married couple (\$5,800 for unmarried individuals). The additional standard deduction for the aged and blind, adjusted for inflation, is \$1,150. Rev. Proc. 2011-12, 2011-2 I.R.B. 297 (Dec. 24, 2010).

**Page 167: In Part C (“Personal and Dependency Exemptions”), insert the following after the third sentence:**

In 2011, it is \$3,700. Rev. Proc. 2011-12.

**Page 168: Replace the material in Section C.3 (“Phase Out Rules”) with the following new material:**

There are rules for phasing out the personal exemptions for higher income individuals. *See* IRC § 151(d)(3). Beginning in 2006, the personal exemption phaseout was gradually eliminated, and in 2010 the phaseout no longer applied. Although repeal of the phaseout was scheduled to sunset at the end of 2010, Congress extended the repeal of the phaseout for two years. Thus, the personal exemption phaseout for high income earners will not apply for 2011 and 2012; such individuals will not be required to reduce the amount of their personal exemptions for these years if their adjusted gross income exceeds certain threshold amounts.

**Page 177: In Related Matters, insert the following new bullet:**

**Social Security Benefits.** In some cases a taxpayer may claim a family member as a dependent even if they receive social security benefits provided the taxpayer provides more than half of the family member’s support. This is because some portion of a person’s social security benefits are not included in gross income. *See* IRC § 86(a). Thus, the recipient of social security benefits may not have gross income in excess of the exemption amount. *See* IRC § 152(d)(1)(B).

**Page 177: In Related Matters, the second to last bullet (“Phase out, Repeal and Revival) should be replaced with the following:**

The 3% rule was phased out in stages from 2006 through 2009 and was repealed for year 2010. IRC § 68(f). In 2011, the 3% reduction was scheduled to be reinstated in its entirety. Pub. L. 107-16, § 901(a)(1). In 2010, however, Congress extended the repeal for two years, through 2012.

## **Chapter 14: Ordinary Tax Rates and Taxpayer Classification**

**Page 202: In Part C.1 (“Marital Status”), in the paragraph on “Domestic Partners,” which carries over from page 201, insert the following after the quote from The Defense of Marriage Act:**

It should be noted that a Massachusetts federal district court recently invalidated this provision of DOMA. *Gill v. Office of Personnel Management*, 699 F.Supp.2d 374 (D. Mass. 2010) (holding “Section 3 of DOMA as applied to Plaintiffs violates the equal protection principles embodied in the Fifth Amendment to the United States Constitution”). The Department of Justice filed an appeal, but then later notified the court that it will cease to defend DOMA in court. (The Bipartisan Legal Advisory Group, an arm of the U.S. House of Representatives, has intervened to defend DOMA.) Although the administration has announced that it will stop defending DOMA in court, it has said that the Executive Branch (which includes the Treasury Department) will continue to enforce the law. For more information on what this means to same sex taxpayers who want to file joint tax returns, see the February 23, 2011, and March 3, 2011, posts on the Same Sex Tax Law Blog, available at <http://law.scu.edu/blog/samesextax/doma-and-the-irs.cfm>. See also Amy S. Elliott, *IRS’s Definition of Marriage—Where It Stands Now*, available at 2011 TNT 42-3(Mar. 3, 2011); Patricia A. Cain, *DOMA and the Internal Revenue Code*, 84 CHI.-KENT L. REV. 481 (2009).

**Page 202: Disregard the last sentence of the first paragraph (which carries over from page 201), and add:**

Subsequent to a change in California community property law that clarified the community status of income of registered domestic partners, the IRS has agreed that *Poe v. Seaborn* does apply and requires that each partner must report one half of their combined incomes on his or her federal return. Priv. Ltr. Rul. 201021048 (May 5, 2010). For some analysis, see Patricia A. Cain, *Taxation of Domestic Partner Benefits: The Hidden Costs*, *University of San Francisco Law Review, Forthcoming, Santa Clara Univ. Legal Studies Research Paper No. 6-11 (available on SSRN)*.

**Page 202: In Section D (“Alternative Minimum Tax”), insert the following after the seventh sentence:**

Congress extended the exemption amounts for 2010 and 2011. For 2010, the exemption amount was \$72,450 for joint filers and \$47,450 for unmarried persons. For 2011, the exemption amount was \$74,450 for joint filers and \$48,450 for unmarried persons.

**Page 205: In Related Matters, replace the first bullet (“Sunset Provision”) with the following:**

Ordinary tax rates were scheduled to sunset in 2011 and revert to pre-2001 rates. In 2010, Congress extended the sunset date for two years. Thus, the following six rate brackets on

ordinary income will continue to apply for years 2011 and 2012: 10%, 15%, 25%, 28%, 33%, and 35%. The inflation adjusted brackets for 2011 for these rates are found in Revenue Procedure 2011-12, 2011-2 I.R.B. 297. These rates are now scheduled to sunset beginning after 2012, and, absent action by Congress, the following pre-2001 rates on ordinary income will once again apply: 15%, 28%, 31%, 36%, and 39.6%.

## **Chapter 15: Tax Credits**

**Page 210: Insert the following at the end of Section A.3 (“The Hope Scholarship Credit and the Lifetime Learning Credit”):**

In 2010, Congress extended these changes for an additional two years, through 2012.

**Page 211: In Section B.2 (“The Earned Income Credit”), the last sentence should be replaced with the following:**

These increases, which originally applied to tax years 2009 and 2010, were recently extended to apply to tax years 2011 and 2012.

**Page 212: In Related Matters, the bullet on “§23 Credit for Qualified Adoption Expenses” should be amended to read as follows:**

§ 36C Credit for Qualified Adoption Expenses. The process of adopting a child can be quite expensive. It is not uncommon for a foreign adoption, for instance, to cost in excess of \$20,000. Section 36C authorizes a tax credit for certain adoption expenses. Like most credits, it has a number of complexities such as expense caps and income phase outs.

**Page 212: In Related Matters, the bullet on “Education Expense Deductions” should be amended by replacing the last two sentences with the following:**

The above-the-line deduction for qualified tuition and related expenses, which expired at the end of 2009, was extended for two years. The deduction is now slated to expire at the end of 2011. However, Congress has extended the life of this provision on more than one occasion and it may do so again.

**Page 212: In Related Matters, the bullet on “Energy Efficient Credits” should be amended by replacing the second sentence with the following:**

At present, it is slated to expire after 2011.

**Page 213: Add the following at the end of the bullet on First-Time Homebuyer Credit (which carries over from page 212):**

For contracts that were in place by April 30, 2010, the Homebuyer Assistance and Improvement Act of 2010 provides a 3-month extension of the closing deadline for the tax credit through September 30, 2010.

**Page 213: Add the following at the end of the section on Related Matters:**

Section 36B, enacted as part of health care reform in March 2010, created a Health Coverage Tax Credit (HCTC). The HCTC is a refundable credit equal to 80% of the costs of certain health care insurance of qualified low income individuals. The provision is effective for tax years after December 31, 2013.

**Chapter 17:  
Capital Gains and Losses**

**Page 219: In the Overview, replace the second sentence in the second paragraph with the following:**

Presently, the maximum rate at which most *long-term capital gains* are taxed is 15% (for tax years through 2012), whereas the highest rate at which other types of income (*ordinary income* and *short-term capital gains*) are taxed is 35% (for tax years through 2012).

**Page 224: In the last paragraph, insert the following parenthetical information after the cite to §1(h)(7):**

[It should be noted that a non-corporate taxpayer may exclude 100% of gain from qualified small business stock acquired after September 27, 2010, and before January 1, 2012, and held for at least five years.]

**Page 234: In Related Matters, the first bullet (“Sunset of Capital Gains Rate”) should be replaced with the following:**

The capital gains rate of 15% (0% for lower bracket taxpayers) was scheduled to sunset beginning in 2011 and revert to the pre-2001 rate of 20% (10% for lower bracket taxpayers). In 2010, however, Congress extended the lower capital gains rates for two years. Thus for 2011 and 2012, the capital gains rate is 15% (or 0% for lower bracket taxpayers).

**Page 234: In Related Matters, the last sentence in the second bullet (“Qualified Dividends”) should be replaced with the following:**

These special rules for qualified dividends were scheduled to sunset beginning in 2011. In 2010, however, Congress extended them for two years, through 2012. Thus, for 2011 and 2012, qualified dividends are taxed at capital gains rates rather than ordinary tax rates. Unless Congress extends this or enacts new rules, dividends will be taxed at ordinary income rates beginning in 2013.

## **Chapter 22: Residential Real Estate**

**Page 290: In Related Matters after the bullet on “Section 121 and Involuntary Conversions” add the following bullet:**

**Section 121 and Like Kind Exchanges.** Property acquired in a like kind exchange and subsequently converted to the taxpayer’s principal residence does not qualify for the section 121 exclusion upon sale or exchange unless the sale or exchange occurs more than 5 years after its acquisition. IRC § 121(d)(10). Like Kind exchanges are addressed in Chapter 24. For the tax treatment of a principal residence that is later the subject of a like kind exchange see Revenue Procedure 2005-14, 2005-1 C.B. 528.

## **Chapter 28: Intellectual Property Development and Acquisitions**

**Page 370: In Related Matters (“Expensing Off-the-Shelf Software”), replace the last sentence with the following:**

Only off-the-shelf software purchased in a tax year beginning after 2002 and before 2013 qualifies for the special deduction under section 179. IRC § 179(d)(1)(A).

## **Chapter 33: Personal Injury Recoveries and Punitive Damages**

**Page 433: Insert the following parenthetical information at the end of the first paragraph:**

[Note: Prop. Treas. Reg. § 1.104-1(c) removes the first condition of *Schleier* (i.e., damages must be received in a tort-like cause of action). Query: What practical effect does this change have? Wouldn’t most plaintiffs who recover from a physical injury satisfy the first prong of *Schleier*?]

## **Chapter 40: Overview of Estate and Gift Tax**

**Pages 528-538: *The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010* revised the temporarily defunct federal estate tax and the generation skipping transfer tax. Due to significant changes in this chapter, replace the entire Chapter with the following new Chapter.**

## **Chapter 40 Overview of Estate and Gift Taxation**

### **I. Assignment**

Read: -Internal Revenue Code: §§ 2001(a)–(c); 2010; 2056(a); 2501; 2503(b); 2505(a). Skim §§

2601-2613; 2631-2641; 2642(c); 2651(e)(1).

-Treasury Regulations: None

Text: Overview

Related Matters

Complete the problems.

## II. Problems

1. In 2011, Captain Kurtz passed away with a gross estate of \$7,100,000. His debts and the costs of administering his estate totaled \$100,000. What is his estate's estate tax liability under the following circumstances?
  - (a) The captain had made no taxable gifts during life. Under his will everything passed to his children, Conrad and Jim.
  - (b) Same as (a) except that the captain had made adjusted taxable gifts of \$1,000,000.
  - (c) Same as (a) except that the captain leaves \$2,000,000 to his wife, Medea, and \$5,000,000 to his children.
2. Mary Todd has four children and ten grandchildren. This year she made outright gifts of \$10,000 in cash to each of these fourteen people. These were her only gifts. What is her "total amount of gifts" within the meaning of section 2503(a)? *See* IRC § 2503(b)(1).
3. In 2011, Mata Hari gave \$6,013,000 to her grandson, Hermann Goering. What are Mata's transfer tax consequences under the following circumstances?
  - (a) Her son Adolf, Hermann's father, is still living at the time of the gift. Mata has her full section 2505 tax credit remaining and she allocates \$1,000,000 of her GSTT exemption to the gift. She requires Hermann to pay any GSTT on the transfer.
  - (b) Same as (a) except that Adolph is no longer living.
  - (c) Same as (a) except that Mata had made a taxable gift of \$500,000 in a prior year.

## III. Overview

### A. Introduction

Throughout this book we have approached various topics within federal taxation with differing degrees of specificity in order to emphasize important points while avoiding information overload. This chapter is the broadest treatment in the book because it surveys an important but quite distinct area of federal taxation, the gratuitous transfer taxes. The purpose of this chapter is give the reader a sense of the structure and operation of these taxes without belaboring the details. Estate and gift taxation and estate planning are fields worthy of full scale study and many books address them in detail.

There are three federal gratuitous transfer taxes: the estate tax (IRC §§ 2001-2058), the gift tax (IRC §§ 2501-2524), and the generation skipping transfer tax (GSTT) (IRC §§ 2601-2664). You may never have heard of the last one. Suffice it to say at this point that it is a tax designed to prevent estate and gift tax avoidance on a generation of transfer tax by the simple device of skipping a generation, e.g., by leaving one's estate to one's grandchildren rather than to one's children.

### ***1. Why Have Such Taxes?***

The transfer taxes are excise taxes on the privilege of giving away one's property to another person. Some people question the fairness and logic of taxing such transfers. Indeed, in 2001 Congress repealed the estate tax and the GSTT (but not the gift tax), effective in 2010. However, due to certain peculiarities of the Senate's rules, the estate tax and GSTT, were slated to spring back into life in year 2011 with all the rules that were in effect in 2001. In December of 2010 Congress reenacted the estate tax and the GSTT. In doing so, it created a larger exemption than had existed previously and imposed a lower rate of tax. These changes are scheduled to expire on January 1, 2013.

There is no absolute justification for these taxes, any more than there is an absolute justification for the income tax, the property tax, or the sales tax. The estate tax probably came into being because death is such a clearly identifiable event that it made taxation relatively easy. Also, dead people are less inclined to resist taxation than most others. The simple fact is that nearly all forms of taxation arise first because of the need to fund the government. "Taxes are the price we pay for a civilized society," Justice Holmes said. Even so, the forms of taxation a nation adopts do say something about its values. An estate tax makes sense in the context of a nation, such as the United States, that does not honor hereditary offices. We do not believe in privilege by birth. The American ideal, if not the reality, is that all women and men are created equal and that the opportunity to gather wealth should exist for everyone in equal measure. In this context the estate tax may be seen as an effort to prevent the aggregation of much of the nation's wealth, and the corresponding power, in the hands of a relatively few families. (This also explains the use of graduated rates.) How well the transfer taxes work to accomplish that goal is a matter of debate. Compared to the income tax, the transfer taxes raise very little revenue. However, they are sometimes credited with encouraging substantial gifts to charities.

### ***2. Who Pays the Transfer Taxes?***

Very few people are affected by the gratuitous transfer taxes. In 2011 an unmarried decedent's estate of less than \$5,000,000 escaped any federal estate tax if the decedent made no lifetime taxable gifts. Thus a married couple could easily pass \$10,000,000 in property to their children tax free. With judicious planning much larger sums could be transferred free of estate or gift tax. A few of the major planning techniques are discussed below.

## **B. Transfer Tax Theory**

There are six basic principles thought to be embodied in a good transfer tax.

1. It should apply to all property a person can transfer.
2. There should be no difference in treatment between inter vivos and testamentary

transfers.

3. Each transfer should be taxed only once.
4. The tax should be imposed at least once each generation.
5. Valuation rules should account for the different ways in which property can be divided.
6. Illiquidity relief should be liberally provided.

Most of these rules derive from a higher principle of tax theory: a tax should be economically neutral. In the present context this means the tax result should be the same no matter how the taxpayer chooses to transfer her property. Thus, she will choose the most rational approach to meet her goals. Neutrality is a general principle of tax theory that is often honored in the breach. The transfer taxes are no exception. The interaction between the transfer taxes and the income tax basis rules is a good illustration of failed neutrality. There is a strong bias in the system in favor of holding appreciated property until death rather than transferring it during life because of the basis step up for bequests afforded by section 1014. Recall that appreciated property given away during life takes a carryover basis under section 1015.

### **C. The Estate Tax in Outline**

The estate tax is borne by a decedent transferor's estate. It is computed by determining the "gross estate" (like gross income in the income tax) and taking certain deductions to derive the "taxable estate." The tax rate schedule is applied to the taxable estate. The resulting tentative tax liability is then reduced by the "unified credit" to arrive at a final tax owed.

#### ***The Conceptual Structure of the Estate Tax***

**Gross Estate**

**– Deductions**

**Taxable Estate**

**× Rate**

**Tentative Tax**

**–Unified Credit**

**Tax Owed**

The actual computation is significantly more complicated because the estate tax is integrated with the gift tax and because of the nominally progressive rate structure embodied in section 2001(c). The apparent progressivity of that rate structure is misleading. In essence the estate tax rate is a flat 35% of the fair market value of that portion of the taxable estate that is not shielded by the unified credit.

#### ***1. The Gross Estate***

The "gross estate" is a non-intuitive concept since it includes many things in addition to property the decedent owned at death. Moreover, significant valuation issues can also arise. The gross estate usually must be valued at its fair market value as of the date of death of the person whose estate is being taxed. IRC § 2031(a).

The gross estate consists of (primarily) 10 categories of property:

1. Property owned at death. § 2033
2. Certain property transferred near death. § 2035
3. Property which was transferred before death but over which the transferor retained some right of enjoyment. § 2036
4. Property which was transferred before death but enjoyment of which was conditioned upon surviving the donor. § 2037
5. Revocably transferred property. § 2038
6. Certain annuities. § 2039
7. Certain jointly held property. § 2040
8. Property over which the decedent held a general power of appointment. §2041
9. Certain life insurance proceeds on the decedent's life. § 2042
10. Certain property in which the decedent held a life interest received from his spouse. § 2044

We will not examine these inclusion rules in any detail. But it is useful to understand that the gross estate can consist of many things beyond the decedent's probate estate. Clearly the completion of an estate tax return or the development of a estate plan for a wealthy person are not tasks for the uninformed.

## ***2. The Taxable Estate***

The taxable estate consists of the sum of the items just noted reduced by certain deductions. These are:

1. Creditor's claims and expenses of the estate. § 2053
2. Casualty losses during administration. § 2054
3. Charitable deduction. § 2055
4. Marital deduction. § 2056

The charitable deduction correlates in many respects with the same deduction for income tax purposes and has many technical limitations, especially for split interest transfers. The deduction for gifts between spouses also requires a further comment. This deduction rests on the idea that a married couple is a single economic unit and, thus, gifts between spouses should be

ignored for transfer tax purposes. But not every gift between spouses qualifies for the deduction. Gifts of lifetime or term interests must be carefully structured in order to qualify. *See* IRC § 2056(b)(7). The marital deduction is a commonly used estate planning tool.

### ***3. The Rate Structure***

The rate structure for both the estate tax and the gift tax is set out in section 2001(c). *See also* IRC § 2502(a). The maximum rate under that provision is 35%.

### ***4. The Unified Credit***

The unified credit is the device that allowed estates of less than \$5,000,000 in 2011 to go untaxed. It is set out in section 2010. The term "unified" refers to the way in which the credit's operation is integrated into a similar gift tax credit found in section 2505. The two credits are of equal amounts. The two credits are unified in one important respect. The use of the gift tax credit had the effect of reducing the available estate tax credit. Thus, in 2011, for example, a \$500,000 taxable inter vivos gift means that a decedent's estate can only shelter \$4,500,000 of property from taxation by use of the estate tax unified credit.

The mechanics of the unified credit are a bit tricky. The statutes establish what is called an "applicable exclusion amount" of \$5,000,000 for the estate tax and for the gift tax. *See* IRC §§ 2010(c), 2505(a). The "applicable credit" is the amount of tax that would otherwise be owed on transfers of those amounts under the section 2001(c) rate structure. Thus, the estate tax credit is \$1,730,800, and the gift tax credit is \$1,730,800.

Two complicating factors are that the unified credit is indexed for inflation after 2011 and, under certain circumstances, any unused credit can be given to a decedent's surviving spouse. *See* § 2010(c).

## **D. The Gift Tax in Outline**

The gift tax serves to backup the estate tax. Without a gift tax one could avoid tax on transfers from one generation to the next by the use of inter vivos gifts. Its structure is similar to that of the estate tax. Its provisions relating to such things as powers of appointments, charitable gifts, and inter-spousal transfers tend to mirror those of the estate tax. However, it does have a few unique rules some which we will note below.

In Chapter 4, we considered the *Duberstein* case which held that for income tax purposes a gift must arise out of "detached and disinterested generosity." This is not the rule in the gift tax context. Instead a gift occurs when there is a transfer of property for less than full and adequate consideration. *See* Treas. Reg. § 25.2511-1(g)(1). In order for a gift to be complete for gift tax purposes the donor must give up "dominion and control" over the property. Treas. Reg. § 25.2511-2(b). Thus, a transfer of property to a revocable trust, for example, is not a completed gift and is not currently taxable. If the trust makes distributions or later becomes irrevocable, the gift tax is triggered at that time.

The gift tax is levied on the transferor (donor). As noted, the rates are established by section 2001(c). *See* § 2502(a). Although an annual return is used, all gifts since 1932 are used to compute the tax rate. Thus, earlier year's gifts push current gifts into higher tax brackets. If you

find this confusing, be patient. Computing the estate and gift taxes is developed further in a moment.

### ***1. The Annual Exclusion***

The first \$10,000 of a present interest gift to anyone is excluded from the gift tax. IRC § 2503(b). (This number is adjusted for inflation and is currently \$13,000.) This is known as the "annual exclusion" and, as its name describes, it arises anew each year. Thus, one can make gifts year after year with no gift tax consequences as long as the amount given to any particular person does not exceed the annual exclusion limit. This is an obvious planning opportunity. For example, a person can make gifts to her children and grandchildren over a span of years in order to spend down her estate to a level where little or no estate tax will apply when she dies. There are several nuances to the annual exclusion. Spouses may double their available exclusion by treating one another's gifts to third parties as being made half by each even though only one spouse actually made the gift. IRC § 2513. Gifts in trust to minor children can qualify if they meet certain terms. *See* IRC § 2503(c). Certain payments for education and for medical care for another are also excluded if made directly to the provider. IRC § 2503(e).

### ***2. Special Valuation Rules***

Valuation poses serious problems in the administration of both the estate and the gift taxes. Well advised taxpayers often slice and dice their property interests in ways that make the value of property highly debatable and hire experts who will testify that the form in which an interest is held reduces its value for transfer tax purposes. For example, a taxpayer may put his property inside a limited partnership and then give away minority interests to his children. Arguably the minority interests are worth less for gift tax purposes than the underlying assets since the limited partner has no control and since the interest may not be readily marketable. Much of the litigation in the estate and gift tax area concerns the value of transferred property interests.

There are a few statutorily adopted valuation rules that attempt to shore up the gift tax against various efforts at tax planning. These rules are found in sections 2701 through 2704. Section 2701 relates to transfers of interests in a corporation or partnership. Section 2702 relates to transfers into a trust. Section 2703 relates to buy-sell agreements, and section 2704 relates to certain lapsing rights and restrictions. We will not analyze these provisions here. We simply observe their existence as a cautionary note for would-be estate planners.

## **E. Computing the Estate and Gift Taxes**

The manner of computing both the estate tax and the gift tax is based on the assumption of a highly progressive rate structure. As we have noted, currently that assumption is not valid. Nonetheless the statutory architecture remains in place and is useful to understand.

Both computations employ a "stacking" concept. That is, in each computation we stack all prior gratuitous transfers beneath the ones that are presently being taxed. Then we compute a tax on the sum of those transfers past and present. Thus the prior transfers push the current transfers into higher tax brackets. We avoid taxing the prior transfers more than once by backing out the prior years' taxes from the current liability.

**1. The Estate Tax Computation**

Not only is the estate tax computation complicated by the use of stacking, but it is also complicated by the fact that inter vivos gifts can reduce the amount of the unified credit that is available at death. The way the statutes arrive at these two results is set out below.

***Estate Tax Computation Worksheet with Statutory Cross-References***

<b>1.</b>	<b>Gross Estate (2031-44)</b>		_____
<b>2.</b>	<b>Total Deductions</b>		
<b>3.</b>	<b>Marital (2056)</b>	_____	
<b>4.</b>	<b>Charitable (2055)</b>	_____	
<b>5.</b>	<b>Casualties (2054)</b>	_____	
<b>6.</b>	<b>Debts (2053)</b>	_____	
<b>7.</b>	<b>Others</b>	_____	
<b>8.</b>	<b>TOTAL</b>		- _____
<b>9.</b>	<b>Taxable Estate (2051, 2001(b)(1)(A))</b>		_____
<b>10.</b>	<b>Adjusted Taxable Gifts (2001(b)(1)(B))</b>		+ _____
<b>11.</b>	<b>Tentative Taxable Estate</b>		_____
<b>12.</b>	<b>Apply 2001(c) rate</b>		<u>× rate</u>
<b>13.</b>	<b>Tentative Estate Tax (2001(b)(1), (c))</b>		_____
<b>14.</b>	<b>Total Taxable Gifts</b>	_____ (2001(b))	
<b>15.</b>	<b>Apply 2001(c) rate</b>	<u>× rate</u>	
<b>16.</b>	<b>Gross Gift Tax</b>	_____ (2001(b)(2))	
<b>17.</b>	<b>Unified Credit</b>	- _____ (2505)	
<b>18.</b>	<b>Gift Tax Payable (2001(b)(2))</b>		- _____
<b>19.</b>	<b>Pre-Credit Estate Tax</b>		_____
<b>20.</b>	<b>Unified Credit (2010)</b>		- _____
<b>21.</b>	<b>Net Estate Tax Liability</b>		_____

Notice that lines 9 (taxable estate) and 10 (adjusted taxable gifts) are added together

before the tentative tax is computed on the sum using the section 2001(c) rate schedule. This is what is designed to push the estate into the higher tax brackets. Then line 18 backs out the gift tax on the prior years' gifts to avoid double taxing them. Finally the tax liability is reduced by the unified credit at line 20 to arrive at the final liability.

For many people the most confusing thing about this computation is that the unified credit gets deducted twice; once at line 17 and again at line 20. The line 17 deduction is the gift tax unified credit, and the line 20 deduction is the estate tax unified credit. Is the credit being allowed twice? The answer is no. The key to understanding this is to observe that the line 17 deduction *reduces* the line 18 amount which is then deducted from the tentative tax. In other words the first use of the credit reduces a tax reduction. Only the second use of the credit reduces the estate tax liability.

## 2. The Gift Tax Computation

The gift tax computation is less complex but still daunting.

### *Gift Tax Computation Worksheet with Statutory Cross-References*

1.	<b><u>Current gross gifts</u></b>	_____
2.	<b><u>-Exclusions</u> (2503(b), (c), (e) &amp; 2513)</b>	- _____
3.	<b>Total amount of gifts (2503(a))</b>	_____
4.	<b><u>-Deductions</u>(e.g. 2523 (marital deduction))</b>	- _____
5.	<b>Current taxable gifts (2503(a))</b>	_____
6.	<b><u>+ Prior years' taxable gifts</u></b>	+ _____
7.	<b>Total tentative taxable gifts</b>	_____
8.	<b>×Rate (2502(a)(1), 2001(c))</b>	× <b><u>rate</u></b>
9.	<b>Tentative tax (2502(a)(1))</b>	_____
10.	<b><u>-Tax on prior years' gifts</u> (2502(a)(2) (Pre-credit))</b>	_____
11.	<b>Gift tax liability before credit</b>	_____
12.	<b><u>-Unused unified credit</u> (2505(a))</b>	- _____
13.	<b>Current gift tax liability</b>	_____

Notice in this computation that on line 10 the prior years' tax is deducted from the tentative tax liability without reduction for the prior use of the unified credit. Then when the unified credit is deducted on line 12 only so much of the unified credit as was not used in prior years is deducted. The reason for doing the computation this way is that we use the current year tax rate schedule to determine the tentative tax even if the rate schedule was different in prior years. But we use the actual amount for prior use of the unified credit to determine how much

unified credit remains available in the current year.

## **F. The Generation Skipping Transfer Tax (GSTT)**

We noted earlier that as a matter of theory an ideal gratuitous transfer tax should apply once each generation. The generation skipping transfer tax (GSTT) is designed to foster that requirement. It is an excise tax on the transfer of property to a person who is more than one generation below the generation of the transferor. The tax is, in the main, a device for closing the loophole that exists in the estate and gift taxes for transfers of property from one generation to another without any tax. To understand this consider the two following examples:

***Example 1.*** Grandfather dies leaving \$10,000,000 to Father who lives off the income but not the principal. Father dies leaving the \$10,000,000 to Granddaughter (Father's daughter, Grandfather's granddaughter).

***Example 2.*** Grandfather dies leaving \$10,000,000 in trust to Father for life, remainder to Granddaughter.

The first example results in the estate tax being applied twice, once when Grandfather dies and again when Father dies. In the second example the termination of Father's life estate does not trigger any estate or gift tax since he was not the transferor. Thus, in the absence of the GSTT, the \$10,000,000 would pass from Grandfather to Granddaughter with only one application of transfer tax. Under the GSTT when Father dies the termination of the trust will trigger the GSTT which will be borne by the trust.

### ***1. The Triggering Event***

The GSTT is triggered by any one of three events: (1) a direct skip, (2) a taxable distribution, or (3) a taxable termination. A direct skip is a transfer subject to estate or gift tax to a "skip person." IRC § 2612(c). A skip person is a natural person who is two or more generations below the transferor. IRC § 2613(a)(1). In addition, a trust is a skip person if all interests in the trust are held by skip persons or if no one other than a skip person can receive a distribution from the trust after the transfer creating the trust. IRC § 2613(a)(2). A taxable distribution is a distribution from a trust to a skip person (other than a taxable termination or a direct skip). IRC § 2612(b). A taxable termination is the termination of any interest held in trust unless after the termination the interest is held by a non-skip person or unless after the termination there can be no distributions from the trust to a skip person. IRC § 2612(a).

### ***2. Generation Assignment***

Generation assignment is a mechanical process. For lineal descendants of the transferor, you simply count generations (e.g., a grandchild is two generations below a grandparent.) IRC § 2651(b)(1). The spouses of lineal descendants are assigned to the descendant's generation. IRC § 2652(c)(2).

Unrelated transferees are assigned generations according to the following rules: (1) If the transferee is not more than 12½ years younger than the transferor, he is assigned to the transferor's generation; (2) If more than 12½ years younger but not more than 37½ years younger than the transferor, the transferee is assigned to one generation below the transferor; and (3) Each

25 years thereafter the transferee is assigned to a new generation. *See* IRC § 2651(d). A spouse is assigned to the transferor's generation so there is no GSTT on a transfer between spouses no matter what their ages. IRC § 2651(c)(1).

### ***3. Deceased Parent Rule***

There are a number of special rules to iron out the wrinkles. One important rule is that a descendant whose parents are deceased at the time of the transfer that creates the descendant's interest moves up to the parent's generation. IRC § 2651(e); Treas. Reg. § 26.2612-1(a)(2). Thus, for example, a gift from a grandparent to a grandchild is not a direct skip if the grandchild's parent is dead.

### ***4. The Taxable Amount and Tax Liability***

The amount against which the tax is levied varies somewhat depending upon several factors including whether it arises out of a direct skip, taxable distribution, or taxable termination. But basically the amount is the fair market value of property interest passing to the skip person (*see* IRC §§ 2621–2623) valued as of the time of the transfer. *See* IRC § 2624(a).

The transferee is liable for the tax on a taxable distribution. The trustee is liable for the tax on a taxable termination. The transferor is liable for the tax on a direct skip. IRC § 2603. Where there is a direct skip, the GSTT paid by the transferor is treated as part of the gift for gift tax purposes. IRC § 2515.

### ***5. The Exemption***

There is an exemption from the GSTT equal to the applicable exclusion amount under section 2010(c) (\$5,000,000 in 2011). The transferor may allocate the exemption to any particular transfers she chooses. IRC § 2631. There are special rules for designating how the exemption is used in the absence of a specific election by the transferor. IRC § 2632. Basically, inter vivos direct skips are allocated first and, at death, direct skips are allocated ahead of trusts created which may result in taxable terminations or distributions. IRC §§ 2632(b) & (c).

If the exemption amount is allocated to a trust, the trust keeps that exemption throughout its existence until there is a gift tax or an estate tax applied to the trust. At that point the new decedent or donor is treated as the transferor for GSTT purposes. Moreover, if the amount of the exemption that is allocated to the trust is less than the value of the trust, there will still be some tax liability at various junctures. It is generally advisable to make trusts either wholly exempt from GSTT or wholly non-exempt. In other words, if the transfers into trust exceed the available exemption amount, two or more trusts should be created, one that is exempt and one that is not exempt. This greatly simplifies management and tax planning down the road.

The importance of the exemption for a select group of wealthy people cannot be over emphasized. Those who can afford to tie up significant wealth in an irrevocable trust can avoid all transfer taxes for many generations by establishing dynastic trusts in states that do not have a rule against perpetuities. These trusts are more commonly established in states such as South Dakota and Delaware that also do not have a state income tax.

## ***6. The Annual Exclusion***

Inter vivos transfers that would otherwise be subject to the GSTT receive the benefit of the section 2503 annual exclusions. See IRC §§ 2642(c), 2611(b), 2612(c)(1). This is an important planning device since one can make annual gifts to grandchildren or to grandchildren's trusts without attracting the GSTT.

## ***7. The Tax Computation***

The GSTT is computed by multiplying "the applicable rate" times "the taxable amount." IRC § 2602.

$$\text{GSTT} = \text{Applicable rate} \times \text{Taxable amount}$$

This is not as simple as it sounds because the applicable rate must be derived through a number of computational steps.

The applicable rate is the product of the "maximum federal rate" and "the inclusion ratio" for the transfer. IRC § 2641(a).

$$\text{Applicable rate} = \text{Maximum federal rate} \times \text{Inclusion ratio}$$

The maximum federal rate is the highest marginal rate imposed by section 2001(c) (35% in 2011-12). IRC § 2641(b).

The inclusion ratio with respect to the transfer is the excess of 1 over "the applicable fraction" determined for the trust from which the transfer is made or, in the case of a direct skip, the applicable fraction determined for the skip. IRC § 2642(a)(1).

$$\text{Inclusion ratio} = 1 - \text{Applicable fraction}$$

The applicable fraction is a fraction the numerator of which is the amount of the GST exemption provided by section 2631 which has been allocated to the trust or to the direct skip. The denominator of the applicable fraction is generally the value of the property transferred. IRC § 2642(a)(2)(B)

$$\text{Applicable fraction} = \frac{\text{GST exemption allocated to trust or direct skip}}{\text{Value of the property transferred}}$$

From the foregoing it should be evident that the applicable rate cannot be determined until the inclusion ratio is known. In turn, the inclusion ratio cannot be determined until the applicable fraction is known. Therefore, we must first derive the applicable fraction, then the inclusion ratio and then the applicable rate. This process is illustrated below.

## ***8. Illustration of the GSTT's Application***

Assume Grandmother decides to make an inter vivos gift of \$1,013,000 to Grandson. This is a direct skip because it is a gift subject to gift tax to a person assigned to a generation two generations below Grandmother. Therefore, it is potentially subject to the GSTT. (This assumes that Grandson's parent who is a lineal descendant of Grandmother is still living.) Grandmother

elects to assign \$250,000 of her exemption amount to the direct skip. She also applies \$1,000,000 of her section 2505 unified credit to the gift.

The annual exclusion is available for this gift. This reduces the amount potentially subject to GSTT to \$1,000,000.

The applicable fraction with respect to this direct skip is  $\frac{1}{4}$ .

$$\frac{1}{4} = \frac{250,000}{1,000,000}$$

The inclusion ratio is  $\frac{3}{4}$ .

$$\frac{3}{4} = 1 - \frac{1}{4}$$

The applicable rate is 26.25%.

$$35\% \times \frac{3}{4} = 26.25\%$$

The amount of GSTT owed on the transfer is \$262,500.

$$\mathbf{\$1,000,000 \text{ (the taxable amount)} \times 26.25\% = 262,500.}$$

If Grandmother pays the GSTT on the transfer that is deemed a further gift for gift tax purposes.

Notice that had Grandmother elected to use \$1,000,000 of her GSTT exemption on the direct skip there would have been no GSTT liability. This is because the applicable fraction would have been 1 (the numerator and the denominator would both have been \$1,000,000) and thus the inclusion ratio would have been zero ( $1 - 1 = 0$ ). Thus the applicable rate would have been zero as well because any number multiplied by zero is zero.

## **9. Conclusion**

The generation skipping transfer tax is designed to be a powerful impediment to the use of such transfers for tax avoidance purposes. The annual exclusion and the exemption amount ameliorate this effect in many cases. The exemption amount can be used in a dynastic trust to create a perpetually exempt trust that will benefit generation after generation.

Like the estate tax, the GSTT is slated to revert to January 1, 2001 levels on January 1, 2013.

## **IV. Materials**

None

## **V. Related Matters**

**Tax Reform.** In Congress proposals for reforming or repealing the estate tax are filed every year. Since the current version is set to expire on December 31, 2012, Congress is likely to take action before then. If it fails to do so, the law as it existed in 2001 will come back into being.

This would have two primary effects: a higher maximum rate of 55% and a reduced applicable exclusion amount of \$1,000,000.

## **Chapter 41: Tax Practice and Procedure**

### **Page 565: Add the following at the end of section V. Related Matters:**

**Transactions Lacking Economic Substance.** In 2010, Congress amended section 6662 to include penalties for understatements attributable to any disallowances of claimed tax benefits arising from transactions lacking economic substance. IRC § 6662(b)(6). This codification of the court-made “economic substance doctrine” is sought to be clarified in section 7701(o). The statute provides, in part, that a “... transaction shall be treated as having economic substance only if--

(A) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and

(B) the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction. IRC § 7701(o)(1).

In practice, determining whether a transaction has economic substance has often proved a knotty problem.