FEDERAL WEALTH TRANSFER TAXATION: CASES AND MATERIALS

FEDERAL WEALTH TRANSFER TAXATION: STUDY PROBLEMS

SIXTH EDITION

2011 Supplement

by

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PREFACE

This supplement is designed to update our casebook and accompanying study problems book: *Federal Wealth Transfer Taxation: Cases and Materials* (6th ed. 2009), and *Federal Wealth Transfer Taxation: Study Problems* (6th ed. 2010). We hereby grant permission to users of *Federal Wealth Transfer Taxation* to distribute copies of this supplement to students, either in hard copy or in electronic form.

This supplement is current through July 15, 2011 and incorporates The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (Pub. L. No. 111-312, 124 Stat. 3296 (2010)), passed by Congress on December 16, 2010, and signed into law by President Obama on December 17, 2010. We want to thank Jack Bogdanski (Lewis & Clark) for his detailed comments on the prior edition of these books.

This is the first update to *Federal Wealth Transfer Taxation* since the July 16, 2010 death of our lead author, mentor, and dear friend, Paul McDaniel. Paul was a co-author of the original edition of this book in 1977, with Hank Gutman, Stanley Surrey, and Bill Warren, and remained as co-author of the five subsequent editions of the book. Being asked to join Paul as a co-author on this book was one of the proudest (and most intimidating) moments of our careers. In working with Paul through the years, we have been repeatedly struck by his encyclopedic knowledge of the tax law, clear yet elegant prose, and organizational genius. But what stands out most for us has been Paul's incredible grace and patience in nurturing two junior co-authors. In this supplement and in future new editions, we will do our best to match the high standards he set. To recognize the continuing influence of Paul's work, we have listed him as co-author.

JAMES R. REPETTI
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July 15, 2011

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PART I

OVERVIEW OF THE FEDERAL WEALTH TRANSFER TAX SYSTEM

CHAPTER 1 – AN HISTORICAL REVIEW

***Casebook* p. 14**: Add new Section J:

SECTION J. THE 2010 ACT: ANOTHER TEMPORARY SOLUTION

On December 16, 2010, Congress passed the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (Pub. L. No. 111-312, 124 Stat. 3296 (2010)), which President Obama signed into law on December 17, 2010. The 2010 Act makes several fundamental changes in the federal wealth transfer taxes, but these changes are scheduled to sunset in 2013. Absent further legislation, the federal wealth transfer taxes will revert to their 2001 status on January 1, 2013.

The 2010 Act reinstates in 2010 the estate tax (unless the decedent's executor elects otherwise, as explained below) and the generation-skipping transfer tax. The estate tax applicable exclusion amount is $5 million and is indexed for inflation beginning in 2012. The maximum estate tax rate is 35%. For 2010 gifts, the applicable exclusion amount is $1 million, and the gift tax rate is 35%. For gifts made in 2011 and 2012, the gift tax is reunified with the estate tax, with a $5 million applicable exclusion amount and a top estate and gift tax rate of 35%. The generation-skipping transfer tax exemption is $5 million in 2010-12. The generation-skipping transfer tax rate is 0% in 2010 and 35% in 2011-2012.

The 2010 Act repeals the § 1022 modified carryover basis rules that would have applied to property acquired from a decedent dying in 2010.

Instead, the recipient of such property acquires a fair market value basis under § 1014. However, the executor of a decedent dying in 2010 may make an election to apply the estate tax law in effect in 2010 prior to the enactment of the 2010 Act (no estate tax, § 1022 modified carryover basis) rather than the 2010 Act (estate tax, stepped-up basis). Such an election must be made in accordance with rules established by the Secretary of the Treasury (which have not been issued as of the date of this Supplement).

Exemptions and Rates, 2002-				
Year	Estate Tax Exemption	Gift Tax Exemption	GST Tax Exemption	Highest Tax Rate
2002	1,000,000	1,000,000	1,000,000	50%
2003	1,000,000	1,000,000	1,120,000	49%
2004	1,500,000	1,000,000	1,500,000	48%
2005	2,000,000	1,000,000	2,000,000	47%
2006	2,000,000	1,000,000	2,000,000	46%
2007	2,000,000	1,000,000	2,000,000	45%
2008	2,000,000	1,000,000	2,000,000	45%
2009	3,500,000	1,000,000	3,500,000	45%
2010	Repeal or 5,000,000	1,000,000	5,000,000	35%(E&G) 0% (GST)
2011	5,000,000	5,000,000	5,000,000	35%
2012	5,000,000*	5,000,000*	5,000,000*	35%
2013-	1,000,000	1,000,000	1,000,000*	55%

* Adjusted for inflation

Exemptions and § 2010(c) Credit-Equivalents, 2002-		
Year	Exemption	Credit
2002-03	1,000,000	345,800
2004-05	1,500,000	555,800
2006-08	2,000,000	780,800
2009	3,500,000	1,455,800
2010	0 or 5,000,000	0 or 1,730,800
2011-12	5,000,000*	1,730,800*
2013-	1,000,000	345,800

* Adjusted for inflation in 2012.

The 2010 Act also provides for the portability of an unused estate and gift (but not generation-skipping) tax exemption between spouses. Any applicable exclusion amount that remains unused as of the death of a spouse in 2011-2012 (the "deceased spousal unused exclusion amount") is available for use by the surviving spouse, as an addition to such surviving spouse's applicable exclusion amount. If a surviving spouse is predeceased by more than one spouse, the amount of the surviving spouse's unused exclusion is the lesser of $5 million or the unused exclusion of the last deceased spouse.

***Study Problems* p. 1.1**: Replace Question 2 with the following:

Question 2

As the casebook supplement notes, the 2010 Act is scheduled to sunset on January 1, 2013, with the estate, gift, and generation-skipping taxes reverting to their 2001 levels: decrease in exemption from $5 million to $1 million, increase in the top rate from 35% to 55%, and

elimination of the portability of unused exemption between spouses. How likely is it – especially in light of the 2012 elections – that the sunset will occur? If Congress and the President intervene, what do you think is the most likely result of such intervention?

CHAPTER 6 – DATA ON U.S. WEALTH AND WEALTH TRANSFER TAXES

***Casebook* p. 42**: Add additional data on distribution of wealth in the United States:

Domhoff, Wealth, Income, and Power

Who Rules America (Jan. 2011)

In the United States, wealth is highly concentrated in a relatively few hands. As of 2007, the top 1% of households (the upper class) owned 34.6% of all privately held wealth, and the next 19% (the managerial, professional, and small business stratum) had 50.5%, which means that just 20% of the people owned a remarkable 85%, leaving only 15% of the wealth for the bottom 80% (wage and salary workers).

Table 1: Distribution of Net Worth in the United States, 1983-2007

	Total Net Worth		
	Top 1 percent	Next 19 percent	Bottom 80 percent
1983	33.8%	47.5%	18.7%
1989	37.4%	46.2%	16.5%
1992	37.2%	46.6%	16.2%
1995	38.5%	45.4%	16.1%
1998	38.1%	45.3%	16.6%
2001	33.4%	51.0%	15.6%
2004	34.3%	50.3%	15.3%
2007	34.6%	50.5%	15.0%

***Casebook* pp. 43-44**: Add additional data in **Table 3 – Number of Taxable Estate Tax Returns Filed as a Percentage of Deaths, Selected Years, 2005-2007**:

Year	Deaths	Taxable Estate Tax Returns Filed	
		Number	Percentage
2005	2,394,516	22,716	0.95
2006	2,373,218	15,031	0.63
2007	2,370,425	16,608	0.70

CHAPTER 9 – BASIC APPLICATION OF THE TRANSFER TAXES

***Casebook* p. 65**: Add the following at the end of the second full paragraph:

The 2010 Act reunifies the gift tax in 2011-2012, with an applicable exclusion amount of $5 million and a top rate of 35%. For 2010, the estate tax applicable exclusion amount is $5 million and the gift tax applicable exclusion amount is $1 million; both have a 35% top rate.

***Casebook* pp. 66-67**: Delete the material beginning with "Illustration of Federal Gift Tax Computation" (p. 66) through the remainder of Section A (p. 67) and replace it with the following:

Illustration of Federal Gift Tax Computation

Gift Tax on Initial Gift

Assume that a donor who has not previously made any taxable gifts made a gift of $5,113,000 in 2011 to her child. She incurs $35,000 of gift tax liability, computed as follows:

Taxable gifts prior to 2011		0
Total gifts in 2011	$5,113,000	
Less: annual exclusion	13,000	
Taxable gifts in 2011		5,100,000
Total taxable gifts (present and prior years)		$5,100,000

Tax payable on $5,100,000 (gifts 1932-2011)	$1,765,800
Less: gift tax on $0 (gifts 1932-2010)	(0)
Tentative tax on 2011 gifts	$1,765,800

Less:		
Unified credit	1,730,800	
Less: Unified credit used in prior years	0	
Unified credit available		1,730,800
Tax on 2011 gifts		$35,000[1]

Gift Tax on Subsequent Gifts

Assume that the same donor makes another gift of $213,000 in 2012 to her child.[2] She incurs $70,000 of gift tax liability, computed as follows:

Taxable gifts prior to 2012		$5,100,000
Total gifts in 2012	$213,000	
Less: annual exclusion	13,000	
Taxable gifts in 2012		200,000
Total taxable gifts (present and prior years)		$5,300,000
Tax payable on $5,300,000 (gifts 1932-2012)		$1,835,800
Less: gift tax on $5,100,000 (gifts 1932-2011)		(1,765,800)
Tentative tax on 2012 gifts		$70,000
Less:		
Unified credit	1,730,800	
Less: unified credit used in prior years	1,730,800	
Unified credit available		0
Tax on 2012 gifts		$70,000[3]

[1] In effect, the $35,000 gift tax represents the 35% tax rate applied to the $100,000 of the gift in excess of the $5 million exemption.

[2] Assume that in 2012, the inflation-adjusted estate tax exclusion amount remains $5 million and that the inflation-adjusted annual exclusion remains $13,000.

[3] In effect, the $70,000 gift tax represents the 35% tax rate applied to the $200,000 of the gift in excess of the $5 million exemption.

The combination of graduated rates and computational cumulation of all lifetime gifts effectively ensures that the donor gets only one run up the graduated rate tables. As a result, each succeeding taxable gift made during the donor's lifetime may be incrementally more costly.

***Casebook* pp. 68-69**: Delete the material beginning with "Illustration of Federal Estate Tax Computation" (p. 68) through the remainder of Section B (pp. 68-69) and replace it with the following:

Illustration of Federal Estate Tax Computation

Assume that the same donor as in the earlier gift tax computations dies in 2013 with a gross estate of $1,100,000 and her estate incurs $100,000 of funeral and administration expenses and has no other deductions. Her estate incurs $350,000 of estate tax liability, computed as follows:[4]

Gross estate	$1,100,000
Less: funeral and administration expenses	100,000
Taxable estate	$1,000,000
Plus: post-1976 taxable gifts	$5,300,000
Total transfers subject to tax	$6,300,000
Tentative tax on total transfers subject to tax	2,185,800
Less: gift tax at § 2001(c)(1) rates on post-1976 gifts	(105,000)[5]

[4] Assume that the 2012 estate tax law continues in effect for 2013. For ease of illustration, this example ignores the application of § 2035(b), discussed in Chapter 24(B)(3).

[5] To prevent the estate from receiving a double benefit from the unified credit, § 2001(b)(2) directs that the tentative estate tax be reduced by the gift tax "payable" on post-1976 gifts, which is the amount of the gift tax less the unified credit. Section 2001(g) makes clear that the rates in effect at the date of the

Tentative tax on estate		$2,080,800
Less credits for:		
Unified credit	$1,730,800	
Total credits against tax		1, 730,800
Estate tax		$350,000[6]

***Casebook* pp. 70-72**: Delete the material beginning with the last paragraph on page 70 through the remainder of Section C (p. 72) and replace it with the following:

The amount of generation-skipping tax is the product of the taxable amount and the applicable rate. Every individual is allowed an exemption ($5 million in 2011-2012, scheduled to revert to $1 million in 2013) to allocate among inter vivos and deathtime transfers. Allocation of the exemption to a particular transfer technically affects the computation of the applicable rate, but the practical effect of an allocation is to exempt from tax the fractional share of the transferred property to which the exemption has been allocated.

The applicable rate is the maximum federal estate tax rate (35% in 2011-2012, scheduled to revert to 55% in 2013), multiplied by an inclusion ratio of 1 minus the applicable fraction. The applicable fraction is, in general, the ratio of the amount of the generation-skipping tax exemption allocated to the transfer over the value of the property transferred.

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decedent's death are used to calculate the gift tax payable, including the unified credit that is subtracted from the gift tax. Because the credit is thus subtracted out for purposes of computing the amount of gift tax which offsets the estate tax, the credit is allowed in computing the final estate tax payable.

[6] In effect, the $350,000 estate tax represents the 35% tax rate applied to the $1,000,000 of the estate in excess of the $5 million exemption.

Thus, if a transferor allocates her entire $5 million exemption to a generation-skipping transfer of $15 million made in 2011, the applicable fraction is 1/3, the inclusion ratio is 2/3, and the applicable rate is 23.33%. If no exemption amount is allocated to a transfer, the inclusion ratio is 1 and the applicable rate is 35%. Because the generation-skipping tax is imposed at an ungraduated flat rate set at the highest estate tax rate, it can be quite costly. Thus, if D leaves her estate in trust with income to her child C for life, remainder to C's children, a taxable termination triggered by C's death in 2011 subjects each dollar's worth of generation-skipping transfer to a tax rate of 35% (ignoring any initial allocation to the trust of D's $5 million exemption).

Illustration of Federal Generation-Skipping Tax Computation

A. Taxable Distribution

Assume A created a trust in 2011 with a corpus of $5,000,000 and elected to allocate $2,000,000 of her generation-skipping tax exemption to the trust. The trustee had discretion to distribute income and principal to B, A's child, and C, A's grandchild, during B's life with remainder to C at B's death. In 2012 the trustee distributed $3,000,000 to C.

Taxable amount $3,000,000

Applicable fraction = $\frac{2{,}000{,}000}{5{,}000{,}000}$

Inclusion ratio = 1 - .4 = .6

Applicable rate = .6 x 35% = 21.0%

Generation-skipping tax . . . . . $ 630,000

B. Taxable Termination

Assume D created a trust in 2011 with a corpus of $10,000,000 and elected to allocate $2,000,000 of his generation-skipping tax exemption to the trust. The trustee had discretion to distribute income or principal to E, D's child, for life, remainder to F, D's grandchild. At E's death in 2012, the trust corpus was $21,025,000. The trustee incurred $25,000 of expenses in terminating the trust.

Value of property in trust	$21,025,000
Less: expenses attributable to termination	25,000
Taxable amount	$21,000,000

$$\text{Applicable fraction} = \frac{2{,}000{,}000}{10{,}000{,}000}$$

Inclusion ratio = 1 - .2 = .8

Applicable rate = .8 x 35% = 28.0%

Generation-skipping tax $5,880,000

C. Direct Skip

Assume G, with a remaining generation-skipping tax exemption of $3,000,000, transfers $10,013,000 outright to grandchild H in 2011.

Value of property received by H	$10,013,000
Less: Gift excluded by § 2503(b)	13,000
Taxable amount	10,000,000

Applicable fraction = $\frac{3,000,000}{10,000,000}$[7]

Inclusion ratio = 1 - .3 = .7

Applicable rate = .7 x 35% = 24.5%

Generation-skipping tax . . . . . 2,450,000[8]

[7] G's unused exemption amount of $3,000,000 is deemed allocated to the direct skip under § 2632(b)(1), unless G elects otherwise.

[8] The $10 million taxable gift gives rise to a gift tax as well as a generation-skipping tax. The generation-skipping tax payable by G is an additional taxable gift by G and generates additional gift tax. § 2515. G's total gifts as a result of this transfer are $12,450,000.

***Study Problems* pp. 5.1 to 5.2**: Replace Questions 1-4 with the following:

I. Application (Text pp. 65-72)

For all questions below, assume that the 2011 estate and gift tax law ($5 million exemption, 35% top rate, and $13,000 gift tax annual exclusion) is in effect for all years.

Question 1

In 2011, Parent (a widow who had made no prior taxable gifts) gave $6,013,000 in cash to Child. What is Parent's gift tax liability?

Question 2

In 2012, Parent in Question (1) gave an additional $1,013,000 in cash to Child. What is Parent's gift tax liability?

Question 3

D, a widower, died in 2013 without ever having made any lifetime gifts. What estate tax would be payable if, at his death, D had the following assets and deductible expenses, claims, and bequests:

Home, car, stock, etc. (included in his gross estate by § 2033)	$1,500,000
Life insurance on D's life paid to his estate (included by § 2042)	1,500,000
Land held in joint tenancy with Child for which D paid the entire purchase price (the full value included by § 2040)	2,600,000
Funeral and administrative expenses (deductible under § 2053)	15,000

Claims against D's estate (deductible under § 2053)	15,000
Charitable bequests (deductible under § 2055)	70,000

Assume for purposes of this question that there are no state death taxes creditable against D's federal estate tax liability under § 2011.

Question 4

Assume that D in Question 3 is Parent in Questions 1 and 2, and that § 2035 does not apply. What is D-Parent's estate tax liability upon her death in 2013?

CHAPTER 10 – COORDINATING THE COMPUTATION OF THE ESTATE AND GIFT TAXES

***Casebook* pp. 74-75**: Delete A. COMPUTATION OF THE ESTATE TAX and replace it with the following:

A. COMPUTATION OF THE ESTATE TAX

The unified gift and estate taxes are in concept imposed at a single rate, prescribed by § 2001(c), on all of an individual's wealth transfers, whether made during life or at death. As the cumulative total of transfers grows, the marginal rate increases. A decedent's "taxable estate" represents the final transfer in a continuing process of wealth transmission that began during life. Lifetime gifts fill the bottom brackets of the rate structure. The transfer of the taxable estate is subject to estate tax beginning at that point within the rate schedule at which lifetime transfers left off.

While § 2505 provides a credit that may relieve the donor of current gift tax liability, the form of that relief—a credit rather than a deduction or exemption—leaves the cumulative total of transfers unaffected for purposes of applying the § 2001(c) rates to cumulative transfers beyond the amount sheltered by the credit. That is, an exemption would have taken the amount exempted "off the top" of the taxable gifts, effectively delivering a benefit at the donor's highest marginal rate bracket. A credit, by contrast, delivers the same benefit to all donors, regardless of the size of their gifts, by sheltering the lowest regions of the base from tax. The credit of $1,730,800 in 2011 equals the gift tax liability under § 2001(c) on cumulative taxable transfers of $5,000,000. Cumulative transfers of $5,000,000 in 2011 fall in the over $500,000 bracket band, to which a 35% marginal rate is applied to

amounts over $500,000. Thus, a donor who makes lifetime taxable gifts of $5,000,000 incurs no gift tax liability, but the first $1 of taxable transfer beyond that point, whether during life or at death, prompts a gift or estate tax liability of 35 cents.

To ensure that the estate tax is imposed at rate levels beginning where lifetime gifts ended, § 2001(b) calculates the estate tax through a two-step process:

(1) A hypothetical estate tax is calculated on the total of the taxable estate and the lifetime gifts, so called "adjusted taxable gifts." Inclusion of lifetime gifts swells the hypothetical tax base, pushing the taxable estate into higher marginal bracket bands.

(2) The gift tax payable on post-1976 taxable gifts is then subtracted.[9] This avoids taxing lifetime gifts twice and leaves as the balance of actual estate tax liability the product of exposing the taxable estate, the amount transferred at death, to the higher ranges of the rate bracket progression.

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[9] The gift tax payable on post-1976 gifts is determined by applying the rates in existence at the time of death to post-1976 gifts and subtracting the unified credit. §§ 2001(b)(2), 2001(g). The legislative history of the 2010 Act states:

> Under the provision, for purposes of determining the amount of gift tax that would have been paid on one or more prior year gifts, the estate tax rates in effect under section 2001(c) at the time of the decedent's death are used to compute both (1) the gift tax imposed by chapter 12 with respect to such gifts, and (2) the unified credit allowed against such gifts under section 2505 (including in computing the applicable credit amount under section 2505(a)(1) and the sum of amounts allowed as a credit for all preceding periods under section 2505(a)(2)).

Joint Committee on Taxation, Technical Explanation of the Revenue Provisions Contained in the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (JCX55-10) 50 n. 52 (Dec. 10, 2010).

***Casebook* pp. 76-77**: Delete the paragraph that begins on the bottom of page 76 and continues onto page 77 and replace it with the following:

Assume, for example, that D made taxable gifts of $5,000,000 in 2011 and died in 2015 leaving a taxable estate of $1,000,000 more. By applying her § 2505 credit, D avoided paying gift tax. Her hypothetical estate tax is computed on a base of $6,000,000 (taxable estate plus adjusted taxable gifts), yielding a gross hypothetical estate tax liability of $2,080,800, which is reduced to $350,000 through application of the § 2010 unified credit. The ultimate result is to tax D's total wealth transfers of $6,000,000 in a manner that relieves the first $5,000,000 of any liability but that exposes the remaining $1,000,000 to the unified rate schedule's 35% bracket. The method of computation automatically limits D to one application of the credit. A taxpayer who fully uses up her gift tax credit during life does not have any remaining credit at death.

Casebook pp. 80-81: Delete the material that begins with the final full paragraph on page 80 and continues through the end of the chapter on page 81 and replace it with the following:

The re-unification of the gift tax and the estate tax in 2011 returns to the forefront the problems inherent in the imperfectly unified systems and should compel the reconsideration of the policy favoring lifetime transfers.

For example, why should there be an incentive for lifetime gifts as compared to testamentary transfers? If the purpose is to move property into younger and, presumably, more venturesome hands, in a desire to produce economic benefits by supposedly increasing the mobility and risk-taking capacity of capital, analysis is then required as to whether this result in fact occurs. If the gifts are in trust, the economic effect is not likely to differ from continued ownership by the donor. If anything, the entrepreneurial enthusiasm of trustees is likely to be substantially muted by legal standards of accountability for prudent behavior to which donors are not subject in investing their own funds. Even if one favors the policy goal, closer analysis of the kinds of gifts that should be encouraged is required. Finally, it must be asked whether there is any justification for effecting the policy through the present inequitable and discriminatory system of encouraging lifetime transfers. Would Congress conceivably approve a direct federal subsidy program for lifetime gifts that provided the largest federal grant to the wealthiest donors and none at all to the least wealthy? It must be recognized that this is precisely the result produced when the present tax incentives for lifetime transfers are translated into a direct subsidy program.

The current system also fails to maximize simplification that could result from complete unification of the substantive rules governing lifetime and deathtime transfers. Separate statutory structures are retained for the estate and gift taxes. In some instances, e.g., transfers incident to a divorce, the rules are actually different. Further, Congress left intact the present unsatisfactory state of the law as to when a gift is "complete" for transfer tax purposes, an issue discussed at p. 299.

Additional legislation would be needed to complete the task of changing the United States' transfer tax structure from a dual to a unified system.

***Study Problems* pp. 5.2 to 5.3**: Replace Question 5 with the following:

II. Coordination (Text pp. 73-81)

Question 5

Compare the total taxes a donor or decedent would pay (assuming only the use of the unified credit, without regard to any exclusions or deductions), if she had assets worth $7,500,000 and:

(a) Held the assets until her death in 2015; or alternatively,

(b) Gave away $6,500,000 in 2011, paid the gift tax out of her remaining assets, and held those assets until her death in 2015.

Assume that the 2011 estate and gift tax law ($5 million exemption, 35% top rate, and $13,000 gift tax annual exclusion) is in effect for all years.

PART II
COMPOSITION OF THE TAX BASE: GENERAL PRINCIPLES

CHAPTER 12 – THE SCOPE OF THE ESTATE TAX: § 2033

***Casebook* p. 109**: Add at the end of Section C:

Joshua Tate, Immortal Fame: Publicity Rights, Taxation, and the Power of Testation, 44 Ga. L. Rev. 1 (2009).

***Casebook* pp. 116-17**: Delete subsections 1-3 of Section A.

***Study Problems* p. 12.3**: Delete Question 8.

CHAPTER 13 – THE SCOPE OF THE GIFT TAX: §§ 2501 AND 2511

***Casebook* p. 130**: Replace the first sentence in B. Policy Issues to read as follows:

Rev. Rul. 64-225, 1964-2 C.B. 15, and Rev. Rul. 66-167 indicate that an executor's waiver of his fee is not treated as a gift to the beneficiaries of the estate if the waiver is made within a reasonable time after commencing to serve as executor and the executor has not taken any action inconsistent with his serving on a gratuitous basis.

***Study Problems* pp. 13.1 to 13.2**: In Questions 4 and 5, change the date to 2012.

***Study Problems* p. 13.2**: Replace Question 6 with the following:

On January 1, 2012, Parent agrees to pay Child $13,000 per year for the next ten years (assume that the 2012 annual exclusion, gift tax rate, and gift tax exemption remain in effect throughout the 2009-2021 period). Assume that the present value of Child's right to $130,000 in the form of the $13,000 annual payment for ten years is $79,879. When is the gift a "completed" transfer for gift tax purposes – in 2012, when Parent makes the binding promise, or each year from 2012-2021 when Child receives the $13,000 payment? What difference does it make?

***Study Problems* p. 13.4**: In Question 11, change the reference to "Question 11" to "Question 10."

***Study Problems* p. 13.5**: In Question 13, change the references to "§ 2501(a)(5)" to "§ 2501(a)(4)."

***Casebook* p. 176**: Add new Section C at the end of the chapter:

C. 2011 DEVELOPMENTS

As this Supplement goes to press (July 15, 2011), two events have thrust the gift tax treatment of political contributions into the national spotlight.

On June 3, 2011, former Democratic vice-presidential candidate John Edwards was indicted on charges that he violated campaign-finance laws by accepting $925,000 from donors to conceal an extramarital affair with Rielle Hunter and resulting pregnancy. Press reports state that 100-year old banking heiress Rachel "Bunny" Mellon provided $700,000 of the funds. Ms. Mellon's attorney claims that she gave the money to Edwards as a personal gift and indeed filed a gift tax return reporting the gift (as well as a generation-skipping tax return). Commentators have

debated the impact of Ms. Mellon's treatment of the transfers as a taxable gift on Mr. Edwards' criminal liability under the campaign-finance laws. See *Will the Gift Tax Save John Edwards?*, TaxProf Blog, June 3, 2011, at http://taxprof.typepad.com/taxprof_blog/2011/06/will-the-.html; *John Edwards and the Gift Tax: A Dissenting View*, TaxProf Blog, June 8, 2011, at http://taxprof.typepad.com/taxprof_blog/2011/06/john-edwards.html; *Why the Gift Tax May Save John Edwards: The New York Precedent*, TaxProf Blog, June 8, 2011, at http://taxprof.typepad.com/taxprof_blog/2011/06/why-the-gift-tax.html.

In the run-up to the 2012 election, § 501(c)(4) organizations are increasingly being used to provide financial support to political candidates and issues. The principal advantage of such groups compared to other types of political organizations is that donors to § 501(c)(4) organizations need not be publicly disclosed. Karl Rove pioneered the use of § 501(c)(4) groups with his Crossroads GPS organization, although Democrats also are making use of these campaign financing vehicles (e.g., Priorities USA). The IRS has announced that it is investigating whether donors to § 501(c)(4) groups must pay gift tax on their contributions because the § 2501(a)(4) gift tax exclusion for contributions to political organizations covers only § 527 organizations, not other political groups such as § 501(c)(4) organizations. Commentators have debated the applicability of the gift tax to contributions to § 501(c)(4) groups, and Republicans have charged that the IRS's investigation is politically motivated:

- *Are Contributions to 501(c)(4) Groups Subject to the Gift Tax?*, TaxProf Blog, Oct. 15, 2010, at http://taxprof.typepad.com/taxprof_blog/2010/10/forbes-are-contributions.html.
- *Are Contributions to American Crossroads, Priorities USA & Other 501(c)(4) Groups Taxable Gifts?*, TaxProf Blog, May 11, 2011, at http://taxprof.typepad.com/taxprof_blog/2011/05/is-the-irs-.html.
- *NY Times: IRS Moves to Tax Contributions to 501(c)(4) Political Groups*, TaxProf Blog, May 13, 2011, at http://taxprof.typepad.com/taxprof_blog/2011/05/ny-times-irs-moves-to-tax-contributions-to-501c4-political-groups.html.

- *IRS Denies Political Influence in Gift Tax Scrutiny of 501(c)(4) Groups*, TaxProf Blog, May 13, 2011, at http://taxprof.typepad.com/taxprof_blog/2011/05/irs-denies.html.
- *Tobin: Application of the Gift Tax to § 501(c)(4) Organizations*, TaxProf Blog, May 16, 2011, at http://taxprof.typepad.com/taxprof_blog/2011/05/tobin-.html.
- *GOP Questions IRS on Applying Gift Tax to Contributions to 501(c)(4) Groups*, TaxProf Blog, May 19, 2011, at http://taxprof.typepad.com/taxprof_blog/2011/05/gop-wants-.html.
- *Gift Tax Seen for Wealthy Donors as IRS Probes Campaign Contributions*, TaxProf Blog, May 25, 2011, at http://taxprof.typepad.com/taxprof_blog/2011/05/gift-.html.
- *IRS Responds to GOP Questions on Application of Gift Tax to 501(c)(4) Groups*, TaxProf Blog, June 4, 2011, at http://taxprof.typepad.com/taxprof_blog/2011/06/irs-responds-.html.
- *GOP Demands Answers From IRS on Gift Tax Probe of 501(c)(4) Groups*, TaxProf Blog, June 15, 2011, at http://taxprof.typepad.com/taxprof_blog/2011/06/gop-demands.html.

PART III
COMPOSITION OF THE TAX BASE: SPECIFIC TRANSFERS

CHAPTER 24 – TRANSFERS MADE WITHIN THREE YEARS OF DEATH

***Casebook* p. 431**: Add at the end of Section A:

In Estate of Morgens v. Commissioner, 133 T.C. 402 (2009), the Tax Court held that gift tax paid by the donee with respect to a decedent's deemed gift of a remainder interest in qualified terminable interest property (QTIP) was includible in her estate under § 2035(b). The Tax Court analogized the deemed gift of QTIP to the net gift in *Estate of Sachs*.

PART IV

EXCLUSIONS, DEDUCTIONS, AND CREDITS NECESSARY TO DEFINE THE TAX BASE

CHAPTER 26 – THE GIFT TAX ANNUAL EXCLUSION: RESOLUTION OF ADMINISTRATIVE PROBLEMS OF TAXING SMALL TRANSFERS

***Casebook* p. 455**: After "See also" in the fifth line from the bottom of the page, replace citations of PLR 199905010 and TAM 9751003 with the following:

Fisher v. United States, 2010-1 U.S.T.C. ¶ 60,588 (S.D. IN 2010) (gifts of LLC interests did not qualify for annual exclusion); Price v. Commissioner, T.C. Memo. 2010-2 (gifts of limited partnership interests did not qualify for annual exclusion).

***Study Problems* p. 26.3**: Add after Question 9:

Question 9A:

Parent formed Family Limited Partnership ("FLP") and transferred $10 million in publicly traded stocks to FLP. Parent retained the sole general partner interest and over the next several years transferred limited partnership interests valued at $13,000 each (after appropriate valuation discounts) to each of his children. Do the gifts of the limited partnership interests qualify for the annual exclusion?

***Casebook* p. 460:** Add at the end of Section K:

For a discussion of the IRS's announced intention to crack down on wealth transfer tax abuses with § 529 plans, including impermissibly leveraging the five-year annual exclusion sanctioned by § 529(c)(2)(B), see Wendy C. Gerzog, *College Savings Plans: Not Just for Education*, 122 Tax Notes 1267 (Mar. 9, 2009).

CHAPTER 27 – ESTATE TAX DEDUCTIONS NECESSARY TO DEFINE THE NET TRANSFER

***Casebook* p. 520**: Add the following case at the end of Section C:

Estate of Shapiro v. United States

634 F.3d 1055 (9th Cir.2011)

■ SILVERMAN, CIRCUIT JUDGE:

Bernard Shapiro and Cora Jane Chenchark lived together for twenty-two years, but they never married. Over those twenty-two years, Chenchark cooked, cleaned, and managed their household. When they broke up, she filed a palimony suit against him in state court. While the suit was pending, he died. In the context of this tax refund lawsuit filed by Shapiro's estate, the district court held that Chenchark's homemaking services did not, as a matter of law, provide sufficient consideration to support a cohabitation contract between Shapiro and Chenchark, and that therefore, an estate tax deduction for the value of Chenchark's claim was properly disallowed. * * *

In determining the value of the taxable estate for purposes of calculating the amount of estate tax owed, the tax code allows a deduction for "claims against the estate . . . as are allowable by the laws of the jurisdiction . . . under which the estate is being administered." § 2053(a). In the case of claims against the estate that are founded on a promise or agreement, this deduction is limited "to the extent that they were contracted bona fide and for an adequate and full consideration in money or money's worth." § 2053(c)(1)(A).

Here, the district court concluded as a matter of law that Chenchark's contributions to the Estate-twenty-two years of cooking, cleaning, and other homemaking services did not constitute sufficient consideration to allow the Estate to deduct her claim against it. The district court did not base its ruling on an application of § 2053(c)(1)(A)'s requirement that the underlying promise or agreement be contracted "for an adequate and full consideration in money or money's worth"; instead, the court rejected the Estate's deduction for Chenchark's claim based on an incorrect reading of Nevada state law regarding contracts between cohabitating partners. * * *

The United States argues that Chenchark's claim is not deductible because it is not supported by "adequate and full consideration in money or money's worth." We do not disagree with the government's point that, under § 2053(c)(1)(A), a claim founded on a promise or agreement, like Chenchark's claim, is only deductible "to the extent [it was] contracted bona fide and for adequate and full consideration in money or money's worth" – but the district court never reached this specific issue. Homemaking services such as those provided by Chenchark can be quantified and have a value attached to them. Our point is simply that these services are not of zero value as a matter of law, as the district court apparently believed.

This is not to say that, even if a factfinder determines that Chenchark's claim was supported by "adequate and full consideration," the Estate is necessarily entitled to the full deduction it seeks. Rather, the value of Chenchark's claim is a factual issue that precludes summary

judgment. The value of the claim (and the corresponding allowable estate tax deduction) remains for the district court to determine on remand. Whether her claim was worth $1 million (as it was eventually settled for) or some other amount is for the district court to decide. * * *

■ TASHIMA, CIRCUIT JUDGE, CONCURRING IN PART AND DISSENTING IN PART:

The majority reverses the district court because its holding "was premised upon a misconstruction of Nevada law regarding contracts between cohabiting individuals . . . ." This case, however, does not turn on issues of state contract law, but on federal tax law, and the Estate has raised no genuine issue of material fact as to whether it has met the requirement of the relevant estate tax provision, i.e., that the claim underlying its deduction be supported by full consideration in money's worth.

The estate tax issue in this case is governed by § 2053. Although the majority is correct that § 2053(a) "allows a deduction for `claims against the estate . . . as are allowable by the laws of the jurisdiction . . . under which the estate is being administered,'" a valid state law claim is a necessary condition for the deduction, but not necessarily a sufficient one. Section 2053 also requires that, to be deductible, claims "founded on a promise or agreement[] be limited to the extent that they were contracted . . . for an adequate and full consideration in money or money's worth[.]" § 2053(c)(1)(A). * * *

The statute's requirement that deductions based on promises or agreements be supported by full consideration in money's worth is based on a need to protect the estate tax. Without this limitation, there would be nothing to "prevent testators from depleting their estates by transforming bequests to the natural objects of their bounty into deductible claims." *Leopold v. United States*, 510 F.2d 617, 623 (9th Cir. 1975). Accordingly, any contract between a decedent and someone who would be a natural object of his or her bounty is viewed with suspicion, requiring exceptional circumstances to be treated as something other than

"simply an agreement to make a testamentary disposition to persons who are the natural objects of one's bounty." *Id*.

Thus, as we have previously held in the context of deductions under § 2053:

> Under exceptional circumstances . . . it may be that a claim by someone who might otherwise inherit from the decedent should be deductible under § 2053. If the claim is not simply a subterfuge for a nondeductible legacy, *if the claim is supported by "adequate and full consideration," and if the consideration is a non-zero sum which augmented the decedent's estate*, then it would seem that the deduction should be allowed. Whether or not a particular claim is deductible, then, will depend on the facts in each case.

Id. at 623-24 (emphasis added). Chenchark, as Shapiro's long-term romantic partner, is a natural object of Shapiro's bounty, who was provided for in his will. Chenchark testified that her claim was based on Shapiro's promise that "if anything happened to him [she] would be taken care of." Accordingly, the test set forth in *Leopold* applies here.

As is clear from the text of § 2053(c)(1)(A) and our decision in *Leopold*, whether or not exceptional circumstances are otherwise presented here, the claim must still be supported by adequate and full consideration that is "a non-zero sum which augmented the decedent's estate." The Estate has adduced no evidence to raise a genuine issue of material fact as to whether Chenchark provided full consideration that augmented Shapiro's estate. As an initial matter, "money or money's worth" appears a number of times in the Internal Revenue Code and regulations, and is generally defined by regulation as excluding love and affection.*** The Tax Court also has observed that love and affection do not constitute adequate consideration for tax purposes.*** Accordingly, any love and affection provided to Shapiro by Chenchark must not, and cannot, be treated as consideration for purposes of § 2053, even if it would support a contract under state law. "Nevada law regarding

contracts between cohabiting individuals" is simply irrelevant to determining the adequacy of consideration under § 2053. * * *

Further, the Estate did not controvert the government's statement in support of its motion for summary judgment that "[d]uring the entire time Chenchark lived with Shapiro, she . . . never contributed any money or other assets of any material value to the relationship." Perhaps more importantly, the Estate itself represented that Chenchark gave nothing of monetary value to the relationship. It represented that Chenchark "was supportive of [Shapiro] emotionally, and supportive of him in the business matters . . . which he sometimes discussed with her. Their association was . . . an intimate, personal association where they shared their lives, hopes and dreams. [Chenchark] gave no physical asset except herself to the relationship . . . ." Further, Shapiro averred before his death that Chenchark "ha[d] never contributed anything to the acquisition or maintenance of any of [his] properties," and Steven R. Scow, one of the co-executors of the Estate, testified that there was no agreement between Shapiro and Chenchark to pool their assets.

Thus, the Estate has not raised a genuine issue of material fact to support its contention that Chenchark's claim against the Estate, assuming arguendo that it was contracted bona fide, was supported by full consideration in money's worth for the purpose of federal tax law. Accordingly, I would affirm the district court on this issue.

***Study Problems* p. 27.4**: Add after Question 10:

Question 10A

Which opinion is more persuasive in *Estate of Shapiro* – Judge Silverman's majority opinion or Judge Tashima's dissenting opinion?

CHAPTER 28 – THE UNIFIED TRANSFER TAX CREDIT

***Casebook* p. 526**: Add before Illustrative Material:

On December 16, 2010, Congress passed the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (Pub. L. No. 111-312, 124 Stat. 3296 (2010)), which President Obama signed into law on December 17, 2010. The 2010 Act makes several fundamental changes in the federal wealth transfer taxes, but these changes are scheduled to sunset in 2013. Absent further legislation, the federal wealth transfer taxes will revert to their 2001 status on January 1, 2013.

The 2010 Act reinstates the estate and generation-skipping transfer taxes in 2010. The estate tax applicable exclusion amount is $5 million and is indexed for inflation beginning in 2012. The maximum estate tax rate is 35%. However, the executor of a decedent dying in 2010 can make an election to not be subject to th estate tax and instead be subject to the income tax carryover basis rules. See Supplement pages 1.1 to 1.2. For 2010 gifts, the applicable exclusion amount is $1 million, and the gift tax rate is 35%. For gifts made in 2011 and 2012, the gift tax is reunified with the estate tax, with a $5 million applicable exclusion amount and a top estate and gift tax rate of 35%. The generation-skipping transfer tax exemption is $5 million in 2010-12. The generation-skipping transfer tax rate is 0% in 2010 and 35% in 2011-2012.

Exemptions and Rates, 2002-				
Year	Estate Tax Exemption	Gift Tax Exemption	GST Tax Exemption	Highest Tax Rate
2002	1,000,000	1,000,000	1,000,000	50%
2003	1,000,000	1,000,000	1,120,000	49%
2004	1,500,000	1,000,000	1,500,000	48%
2005	2,000,000	1,000,000	2,000,000	47%
2006	2,000,000	1,000,000	2,000,000	46%
2007	2,000,000	1,000,000	2,000,000	45%
2008	2,000,000	1,000,000	2,000,000	45%
2009	3,500,000	1,000,000	3,500,000	45%
2010	Repeal or 5,000,000	1,000,000	5,000,000	35%(E&G) 0% (GST)
2011	5,000,000	5,000,000	5,000,000	35%
2012	5,000,000*	5,000,000*	5,000,000*	35%
2013-	1,000,000	1,000,000	1,000,000*	55%

* Adjusted for inflation

Exemptions and § 2010(c) Credit-Equivalents, 2002-		
Year	Exemption	Credit
2002-03	1,000,000	345,800
2004-05	1,500,000	555,800
2006-08	2,000,000	780,800
2009	3,500,000	1,455,800
2010	0 or 5,000,000	0 or 1,730,800
2011-12	5,000,000*	1,730,800*
2013-	1,000,000	345,800

* Adjusted for inflation in 2012.

Joint Committee on Taxation, Technical Explanation of the Relevant Provisions Contained in the "Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010" (JCX-55-10) (Dec. 10, 2010)

* * *

Portability of unused exemption between spouses

Under the provision, any applicable exclusion amount that remains unused as of the death of a spouse who dies after December 31, 2010 (the "deceased spousal unused exclusion amount"), generally is available for use by the surviving spouse, as an addition to such surviving spouse's applicable exclusion amount.[1]

[1] The provision does not allow a surviving spouse to use the unused generation skipping transfer tax exemption of a predeceased spouse.

If a surviving spouse is predeceased by more than one spouse, the amount of unused exclusion that is available for use by such surviving spouse is limited to the lesser of $5 million or the unused exclusion of the last such deceased spouse.[2] A surviving spouse may use the predeceased spousal carryover amount in addition to such surviving spouse's own $5 million exclusion for taxable transfers made during life or at death.

A deceased spousal unused exclusion amount is available to a surviving spouse only if an election is made on a timely filed estate tax return (including extensions) of the predeceased spouse on which such amount is computed, regardless of whether the estate of the predeceased spouse otherwise is required to file an estate tax return. In addition, notwithstanding the statute of limitations for assessing estate or gift tax with respect to a predeceased spouse, the Secretary of the Treasury may examine the return of a predeceased spouse for purposes of determining the deceased spousal unused exclusion amount available for use by the surviving spouse. The Secretary of the Treasury shall prescribe regulations as may be appropriate and necessary to carry out the rules described in this paragraph.

Example 1. – Assume that Husband 1 dies in 2011, having made taxable transfers of $3 million and having no taxable estate. An election is made on Husband 1's estate tax return to permit Wife to use Husband 1's deceased spousal unused exclusion amount. As of Husband 1's death, Wife has made no taxable gifts. Thereafter, Wife's applicable exclusion amount is $7 million (her $5 million basic exclusion amount plus $2 million deceased spousal unused exclusion amount from Husband 1), which she may use for lifetime gifts or for transfers at death.

Example 2. – Assume the same facts as in Example 1, except that Wife subsequently marries Husband 2. Husband 2 also predeceases

[2] The last deceased spouse limitation applies whether or not the last deceased spouse has any unused exclusion or the last deceased spouse's estate makes a timely election.

Wife, having made $4 million in taxable transfers and having no taxable estate. An election is made on Husband 2's estate tax return to permit Wife to use Husband 2's deceased spousal unused exclusion amount. Although the combined amount of unused exclusion of Husband 1 and Husband 2 is $3 million ($2 million for Husband 1 and $1 million for Husband 2), only Husband 2's $1 million unused exclusion is available for use by Wife, because the deceased spousal unused exclusion amount is limited to the lesser of the basic exclusion amount ($5 million) or the unused exclusion of the last deceased spouse of the surviving spouse (here, Husband 2's $1 million unused exclusion). Thereafter, Wife's applicable exclusion amount is $6 million (her $5 million basic exclusion amount plus $1 million deceased spousal unused exclusion amount from Husband 2), which she may use for lifetime gifts or for transfers at death.

Example 3. – Assume the same facts as in Examples 1 and 2, except that Wife predeceases Husband 2. Following Husband 1's death, Wife's applicable exclusion amount is $7 million (her $5 million basic exclusion amount plus $2 million deceased spousal unused exclusion amount from Husband 1). Wife made no taxable transfers and has a taxable estate of $3 million. An election is made on Wife's estate tax return to permit Husband 2 to use Wife's deceased spousal unused exclusion amount, which is $4 million (Wife's $7 million applicable exclusion amount less her $3 million taxable estate). Under the provision, Husband 2's applicable exclusion amount is increased by $4 million, i.e., the amount of deceased spousal unused exclusion amount of Wife.

Sunset provision

Under the bill, the sunset of the EGTRRA estate, gift, and generation skipping transfer tax provisions, scheduled to apply to estates of decedents dying, gifts made, or generation skipping transfers after December 31, 2010, is extended to apply to estates of decedents dying, gifts made, or generation skipping transfers after December 31, 2012. The EGTRRA sunset, as extended by the bill, applies to the amendments

made by the provision. Therefore, neither the EGTRRA rules nor the new rules of the provision will apply to estates of decedents dying, gifts made, or generation skipping transfers made after December 31, 2012.

***Casebook* pp. 526-30**: Replace the Illustrative Material with the following:

ILLUSTRATIVE MATERIAL

A. TECHNICAL ASPECTS OF THE UNIFIED CREDIT

Prior to 2004, the credit was "unified" in the sense that it was available against gift taxes incurred on lifetime transfers (§ 2505), as well as against estate taxes incurred on testamentary transfers (§ 2010). Under this regime, a decedent who had made lifetime gifts did not get the benefit of two credits; the credit was used only once to eliminate transfer tax on the first $1,000,000 (in 2002-03) of taxable gifts and bequests. The unified credit was mandatory—a taxpayer is required to use it to reduce gift taxes and cannot preserve it to be used entirely against estate tax. Rev.Rul. 79-398, 1979-2 C.B. 338.[3]

Beginning in 2004, the credit for gift tax purposes was only partially unified with the credit for estate tax purposes, as the gift tax exemption remained $1 million while the estate tax exemption increased in stages from $1.5 million in 2004-2005, to $2 million in 2006-2008, to $3.5 million in 2009. Under the 2010 Act, the gift tax and estate tax remained only partially unified, with the gift tax exemption at $1 million (with a

[3] A transferor could obtain a greater tax benefit by foregoing the unified credit and paying gift tax on inter vivos transfers and using the credit against the estate tax on testamentary transfers because the gift tax is tax-*exclusive* (meaning that the amount paid as gift tax is not itself subject to transfer tax) while the estate tax is tax-*inclusive* (meaning that the amount paid as estate tax is a part of the estate against which the tax is computed).

35% rate) while the estates of decedents dying in 2010 could choose between the estate tax for 2010 established in the 2001 Act (no estate tax, carryover basis to heirs) or the estate tax for 2010 established in the 2010 Act (estate tax with $5 million exemption and 35% rate, step-up basis to heirs). Beginning in 2011, the gift tax is fully unified with the estate tax: 2011-2012: $5 million exemption (adjusted for inflation in 2012), 2013- : $1 million exemption.

B. THE LEVEL OF TRANSFER TAXATION

1. In General

Setting the appropriate transfer tax exemption—or credit level—amount raises fundamental issues about the overall level of transfer taxation. On what transfers should the tax fall? What should the burden be on the transfers that are subject to tax?

It is easy to lose perspective in considering the transfer taxes. In one aspect they resemble the income tax, for they exempt a basic amount from tax (through the unified credit) and then apply a progressive rate scale. As a consequence, one is apt to approach these taxes with individual income tax attitudes, such as be careful about making the exempt level too low, be careful about the height of the starting rates, be careful about the pace of progression. But such income tax attitudes derive from the fact that our present income tax has a wide coverage of the population. These income tax attitudes have real meaning and force under such circumstances.

But the starting point of "wealth," the distribution of wealth, and consequently the universe occupied by the transfer taxes, are far different. In such a universe, income tax attitudes can easily lead one astray. Thus, in 2011-12, the estate tax will be imposed on the estates of decedents with net worth of over $5,000,000. Yet, far less than 1% of adult decedents leave taxable estates of over this amount. Everything that takes place in the estate tax thus concerns no far less than 1% of adult decedents, while everything that takes place in our individual income tax

concerns most of the adult population (although in recent years, the percentage of adults who pay income tax has declined to nearly 50%). The 2010 as currently in force calls for the estate tax in 2013 and following to be imposed on the estates of decedents with net worth of over $1,000,000, which would reach roughly 2% of adult decedents.

There is a vast difference between speaking of the "little person" under the individual income tax and the "small estate" under the estate tax. Yet Congress and others often carry over to the "small estate" the protectionist attitudes involved in the reference to the "little person." The "small estate," it is true, is less than a dwarf in the scale of large estates, but viewed from the perspective of almost all of our population the "small estate" represents wealth beyond the realities of most everyone. That perspective must be kept constantly in mind in evaluating the effectiveness of the present system in taxing the transfer of wealth in the United States.

The level of transfer taxation, and the resulting burden it imposes, are determined by the point at which estates become subject to tax and the positive rate structure applied to the transfer tax base (assuming that the base has been established on sound and fair principles).

Essentially, the determinants of the starting point and the rate levels to be used for a tax on the transfer of wealth will be the views held on the social desirability—or undesirability—of inheritances and on the overall degree of progressivity in the federal tax system. The transfer tax is the principal factor—the only direct factor—operating to control the size of inheritances. It combines with the individual income tax in shaping directly the progressivity of the federal tax system. Views on these matters seem more directly relevant to the level of rates than the matter of absolute revenue needs. It should be observed, though, that revenue raised by a transfer tax on wealth makes it unnecessary to raise that same amount through other taxes and, in the catalogue of taxes to be utilized by a government, a transfer tax on wealth has a high rating. Dollar for dollar, the funds it raises will provide fewer problems than those created by placing a similar revenue load on other types of taxes.

This being so, those holding strong views on the desirability of limiting inheritances or on strengthening the progressivity of the tax system, and thus urging a high level of rates, will thereby be producing a revenue yield that also would be viewed by some as a useful purpose in itself.

2. *Setting the Level Below Which Transfers Should be Exempt from Tax*

The increase in the estate tax exemption in the 2001 Act and 2010 Act from $1 million in 2003 to $5 million in 2010-11 reflects Congress's desire to encourage saving, promote capital formation and entrepreneurial activity, and help preserve existing family-owned farms and businesses.[4] Indeed, the credit initially was set at an effective exemption amount of $120,667 in 1977, and its growth over the subsequent thirty-plus has exceeded the actual and expected inflation rate over this period:[5]

[4] There is, however, little evidence that the estate tax affects these activities. See James R. Repetti, Democracy, Taxes and Wealth, 76 N.Y.U. L. Rev. 825, 858-73 (2001).

[5] For example, $120,667 in 1977 is the equivalent of $434,194 in 2010 dollars.

EXEMPTION EQUIVALENT OF THE ESTATE TAX CREDIT: 1977-2013	
Year	Exemption Equivalent
1977	$120,667
1978	$134,000
1979	$147,333
1980	$161,563
1981	$175,625
1982	$225,000
1983	$275,000
1984	$325,000
1985	$400,000
1986	$500,000
1987-1997	$600,000
1998	$625,000
1999	$650,000
2000-2001	$675,000
2002-2003	$1,000,000
2004-2005	$1,500,000
2006-2008	$2,000,000
2009	$3,500,000
2010	0 or $5,000,000
2011-2012	$5,000,000
2013-	$1,000,000

Other commentators have proposed a different tack, arguing that a lowering of the exemption level, even a significant lowering, would still keep the transfer tax a rather exclusive levy. What exemption level is required to keep most small or average estates outside the scope of the tax? One possible figure is approximately $135,000.[6]

The next question is whether there are persons receiving property from a decedent who are entitled to claim that a higher figure should be used. Thus, what about the interests of a surviving spouse? But here the marital deduction (discussed p. 572) provides the answer. An unlimited marital deduction protects the interests of a surviving spouse in full. So, given the unlimited marital deduction, the interests of a surviving spouse do not require an exemption higher than $100,000.

What about surviving children? Professor Boris Bittker has pointed out that in all probability the surviving children of decedents possessing more than $100,000 of wealth are likely themselves to be adults and even adults well along in life. Although adult children may welcome inheritances, their claims usually are not founded on the need or hardship that can arise when the provision of support is suddenly removed, as would be the case for a minor child. The inquiry therefore can be shifted to minor children. Where there is a surviving parent, the marital deduction would ensure that surviving minor children have the benefit of the full amount of the decedent's estate unburdened by transfer taxes. The issue thus is narrowed to minor orphan children who would

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[6] Bittker, Federal Estate Tax Reform: Exemptions and Rates, 57 A.B.A. J. 236 (1971), suggested a figure of $25,000. The text figure reflects an adjustment for inflation between 1971 and 2011. Others propose lower amounts (e.g., Westfall, Revitalizing the Federal Estate and Gift Taxes, 83 Harv.L.Rev. 986 (1970) ($20,000, or approximately $1172,000 in 2011 dollars)); others suggest higher amounts (e.g., Ascher, Curtailing Inherited Wealth, 89 Mich. L. Rev. 69 (1990) ($250,000, or approximately $432,000 in 2011 dollars)). In order to eliminate minor current gifts for administrative reasons, there could be a small annual per donee exclusion. See p. 446.

be left with inadequate financial resources to replace the loss of support provided by the deceased parents. The straight-forward response to this problem is a program of direct financial aid to such children (or, less desirably, a special tax credit or deduction for transfers to such children). In any event, the existence of a relatively few needy orphans cannot justify a high exemption level for the estate of every decedent.

What about liquidity problems, allegedly encountered by decedents who die owning farms or small businesses? Although Congress has cited these concerns in raising the credit amount, the data indicate that the vast majority of assets owned by decedents consists of highly liquid forms of property, such as stocks, bonds, life insurance, and cash. Thus, only a very small part of the revenue loss actually benefits decedents owning farms and small businesses. And the Code contains several special measures designed to meet the liquidity needs of these estates at relatively small revenue cost, including §§ 2033A and 6166. Owners of farms and small businesses thus do not have strong claims to a higher exemption level.

This discussion leads to the conclusion that the only consideration for establishing the point at which positive tax rates are begun should be determining the level below which administrative costs (both to the government and to taxpayers) are excessive in relation to the amount of tax collected. This figure could be adjusted annually for inflation (as is the case with the gift tax annual exclusion, and as is the case for 2012 with the exemption). Relying on periodic Congressional increases in the exemption amount is problematic; as seen with the 2001 and 2010 Acts, Congress often increases the exemption amount by far more than would have been justified by inflation.

3. *The Setting of Transfer Tax Rates*

Once the exemption level is established, attention then shifts to the rate structure to be employed. Several questions must be faced, including the degree of progressivity desired, which may be affected both by the rates themselves and the width of the brackets to which the rates apply, and the top rate which should be employed. There is no single

rate and bracket structure that all would agree is appropriate. Indeed, both rates and brackets have been adapted from time to time as Congress has reflected changes in societal attitudes on issues such as the distribution (or concentration) of wealth in the country, the impact of inflation on asset values, and the like.

There have been numerous suggestions concerning the appropriate rate structure for the transfer tax, ranging from suggestions for reductions in existing rates to imposition of a 100% marginal rate for estates above a given value. Present law falls between these positions by adopting a very high exemption level but employing a relatively high starting rate for transfers above the exemption level. In 2011-12, § 2001(c)(1) imposes a flat 35% rate on amounts in excess of $500,000; the first $500,000 is subject to a $155,800 tax (an effective 31.16% rate). Many commentators view the quick jump from a 0% rate to a 45% rate as excessive. Reducing the exemption level would permit Congress to set a much lower initial positive rate and smooth the tax progressivity in a way that § 2001(c)(1) nominally suggests.

Consensus on the appropriate level of transfer taxation is difficult to discern. But it is important for those considering revision of the transfer taxes to understand that the burden of a transfer tax raises questions independent of the structure of such a tax. These questions in turn require detailed research involving quantitative aspects of the distribution of wealth, qualitative studies on the uses of wealth, and consideration of the value judgments of the American people on the appropriateness of transfers of wealth and inherited wealth.

Study Problems p. 28.1: Replace Question 1 and 2 with the following:

Question 1

What do you think is a "fair" level of the exemption amount of the unified credit? $500,000 (to keep most smaller estates outside of the wealth transfer tax system)? $1 million (the 2002 credit and the amount scheduled to be the credit in 2013-)? $2 million (the 2006-2008 credit)? $3.5 million (the 2009 credit)? $5 million (the 2010-12 credit)? Some other figure? Note that the new portability of the credit beginning in 2011 effectively doubles the exemption amount of the unified credit for married couples, a result that prior to the 2010 Act only could be attained with proper marital deduction planning (Chapter 32).

Question 2

Please compute the wealth transfer tax liability in the following transactions. For purposes of this question, assume that the 2011 estate and gift tax law ($5 million exemption, 35% top rate, and $13,000 gift tax annual exclusion) is in effect for all years.

(a) In 2011, Parent makes her first taxable gift of $5,513,000 to Child.

(b) In 2012, Parent makes a second taxable gift of $513,000 to Child.

(c) In 2017, Parent dies with a taxable estate of $2,000,000.

Question 3

Husband and Wife have been married for 50 years and live in Assisted Living Facility. Husband dies in 2011 having made zero taxable transfers and having no taxable estate. An election is made on Husband's estate tax return to permit Wife to use Husband's deceased spousal unused exclusion amount. Widower, who lives in Assisted Living Facility, has made no taxable transfers, and has $20 million of

assets, marries Wife. Wife dies after having made no taxable transfers with a taxable estate of zero. An election is made on Wife's estate tax return to permit Widower to use Wife's deceased spousal unused exclusion amount. What is Widower's applicable exclusion amount?

PART VI
THE TAXABLE UNIT

CHAPTER 32 – THE MARITAL DEDUCTION

***Study Problems* pp. 32.1 to 32.2**: Replace Question 1 with the following:

Question 1

In 2011, Husband has $10,000,000 of assets and Wife has no assets. For purposes of this question, assume that the 2011 estate and gift tax law ($5 million exemption, 35% top rate, and $13,000 gift tax annual exclusion) is in effect for all years..

(a) If they live in a common law state, what is Husband's estate tax liability if he dies first and leaves all of his assets to his wife and there is no marital deduction?

(b) If they live in a community property state, what is Husband's estate tax liability if he dies first and leaves all of his assets to his wife and there is no marital deduction?

(c) Assuming the same facts as in (a), what is Wife's estate tax liability if she dies several years later with the same amount of assets received from Husband? What is the couple's combined estate tax liability in the two estates?

(d) Assuming the same facts as in (b), what is Wife's estate tax liability if she dies several years later with the same amount of assets received from Husband? What is the couple's combined estate tax liability in the two estates?

(e) How do the results change in (a) through (d) under the current unlimited marital deduction?

***Casebook* p. 577:** Replace the last paragraph in "A. STATUS AS SURVIVING 'SPOUSE'" with the following:

As this Supplement goes to press, same-sex couples are permitted to marry as a matter of state law in Connecticut, Iowa, Massachusetts, New Hampshire, New York, Vermont, and Washington, D.C. Under the Defense of Marriage Act, Pub. L. No. 104-199, 110 Stat. 2419 (1996) (codified at 1 U.S.C. § 7 and 28 U.S.C. § 1738C),such marriages are not recognized for purposes of federal law. As a result, such couples are not eligible for the marital deduction and other federal tax provisions applicable to married heterosexual couples. See Patricia A. Cain, DOMA and the Internal Revenue Code, 84 Chi-Kent L. Rev. 481 (2009). There are several pending cases challenging the constitutionality of the denial of the unlimited marital deduction to same-sex couples, and the Obama Administration's Department of Justice has announced that it will no longer defend the constitutionality of DOMA in court.

***Study Problems* p. 32.6**: Change $4,000,000 in Question 17 to $6,000,000.

***Study Problems* p. 32.9**: Change $4,000,000 in Question 28 to $6,000,000.

***Study Problems* p. 32.10**: Change $4,000,000 in Question 30 to $6,000,000.

***Study Problems* p. 32.12**: In Question 37, change $6,000,000 to $8,000,000 and $3,000,000 to $4,000,000.

***Study Problems* pp. 32.14 to 32.15**: Replace Questions 45-46 with the following:

III. The Gift Tax Marital Deduction (Text pp. 637-638)

Question 45

In 2011, Husband has $10,000,000 of assets in his own name and Wife has no assets in her own name. Husband transfers $5,000,000 into a QTIP trust: income to Wife for life, remainder to their children.

(a) Who must elect QTIP treatment?

(b) Is the QTIP trust included in Husband's estate at his death in 2012?

(c) Is the QTIP trust included in Wife's estate at her death in 2016?

IV. Split Gifts (Text pp. 638-640)

Question 46

In 2011, Husband gives $253,000 to Child 1 and Wife gives $53,000 to Child 2.

(a) What is the amount of the taxable gifts made by Husband and Wife if they do not elect to split the gifts?

(b) What is the amount of the taxable gifts made by Husband and Wife if they elect to split the gifts?

(c) How could Husband and Wife achieve the same tax result in (b) without electing to split the gifts?

(d) Are there any situations in which it would *not* be advantageous for Husband and Wife to split the gifts?

***Casebook* p. 642:** In the first line of the third full paragraph, add the word "temporarily" before the phrase "ended all debate." After the third full paragraph, insert:

The planned return in 2013 to the 2001 rate schedule and a small unified credit might cause some to again advocate estate equalization. However, the possibility that the estate tax will be repealed would support maximum deferral. The result is significant uncertainty about which strategy should be employed going forward.

***Casebook* p. 644:** Add at the end of Section 3:

The 2010 Act's provision for the portability of unused exemption between spouses removes the need for spouses to carefully calibrate their marital deduction giving in 2011 and 2012. But because the new portability rules are scheduled to expire in 2013 absent further legislation, it remains to be seen whether couples again will need to ensure that each spouse absorb his or her own exemption equivalent of the unified credit.

***Study Problems* pp. 32.15 to 32.18**: Replace Questions 47-50 with the following:

V. Planning Considerations (Text pp. 640-644)

In Question 47-50, assume that the 2011 estate and gift tax exemption, exclusion, and rates ($5 million exemption, $13,000 gift tax annual exclusion, and 35% top rate) is in effect for all years, and that there is *no portability* of unused exemption between spouses. Assume also that a transfer to a "marital trust" for the benefit of the surviving spouse is a transfer that is eligible for the marital deduction (and in which their children may have an interest); that a transfer to a "family trust" for the benefit of their children is a transfer that is not eligible for the marital deduction (and in which the surviving spouse may have an

interest); that Husband and Wife have not made any prior taxable gifts; and that there are no state death taxes creditable under § 2011. For each Question, compute the estate tax liability for Husband and Wife, and describe the estate planning lessons drawn from the Question.

Question 47

Husband has $5,000,000 of assets and Wife has $0 of assets.

(a) Husband dies first and leaves $5,000,000 to a family trust.

(b) Husband dies first and leaves $5,000,000 to a marital trust.

(c) Wife dies first.

Question 48

Husband has $10,000,000 of assets and Wife has $0 of assets.

(a) Husband dies first and leaves $10,000,000 to a family trust.

(b) Husband dies first and leaves $10,000,000 to a marital trust.

(c) Husband dies first and leaves $5,000,000 to a family trust and $5,000,000 to a marital trust.

(d) Wife dies first.

(e) Prior to the death of either spouse, Husband makes an inter vivos transfer of $5,000,000 to Wife. Husband dies first and leaves $5,000,000 to a family trust.

(f) Prior to the death of either spouse, Husband makes an inter vivos transfer of $5,000,000 to Wife. Wife dies first and leaves $5,000,000 to a family trust.

Question 49

Husband has $15,000,000 of assets and Wife has $0 of assets.

(a) Husband dies first and leaves $15,000,000 to a family trust.

(b) Husband dies first and leaves $15,000,000 to a marital trust.

(c) Husband dies first and leaves $5,000,000 to a family trust and $10,000,000 to a marital trust.

(d) Wife dies first.

(e) Prior to the death of either spouse, Husband makes an inter vivos transfer of 5,000,000 to Wife. Husband dies first and leaves $5,000,000 to a family trust and $5,000,000 to a marital trust.

(f) Prior to the death of either spouse, Husband makes an inter vivos transfer of $5,000,000 to Wife. Wife dies first and leaves $5,000,000 to a family trust.

Question 50

Assume the same facts as Question 49 (Husband with $15,000,000 of assets and Wife with $0 of assets):

(a) Again, what are the tax consequences of Question 49(e): Prior to the death of either spouse, Husband makes an inter vivos transfer of $5,000,000 to Wife. Husband dies first and leaves $5,000,000 to a family trust and $5,000,000 to a marital trust.

(b) Again, what are the tax consequences of Question 49(f): Prior to the death of either spouse, Husband makes an

inter vivos transfer of $5,000,000 to Wife. Wife dies first and leaves $5,000,000 to a family trust.

(c) Would it be better in (a) for Husband to equalize estates by making an inter vivos transfer of $7,500,000 (rather than $5,000,000) to Wife? Assume Husband again dies first and leaves $5,000,000 to a family trust and $2,500,000 (rather than $5,000,000) to a marital trust.

(d) Would it be better in (b) for Husband to equalize estates by making an inter vivos transfer of $7,500,000 (rather than 5,000,000) to Wife? Assume Wife again dies first and leaves $5,000,000 to a family trust and $2,500,000 to a marital trust.

(e) Would it be better in (c) for Husband, on his death, to leave $7,500,000 (rather than $5,000,000) to a family trust and $0 (rather than $2,500,000) to a marital trust?

(f) Would it be better in (d) for Wife, on her death, to leave $7,500,000 (rather than $5,000,000) to a family trust and $0 (rather than $2,500,000) to a marital trust?

***Study Problems* p. 32-18**: Add new Question 51:

Question 51

How would your answers change in Questions 47-50 if there is portability of unused exemption between spouses?

PART VII

THE TAXATION OF TRANSFERS FROM GENERATION TO GENERATION

CHAPTER 33 – THE GENERATION-SKIPPING TAX

***Casebook* p. 648-674**: Delete Chapter 33 in its entirety and replace it with:

SECTION A. THE CONCEPT OF PERIODICITY IN A TRANSFER TAX

There are several policy reasons for imposing a transfer tax on every generation. First, the concept of horizontal equity in a normative transfer tax requires that two taxable units, each transferring the same amount of wealth, pay the same amount of transfer tax. To achieve this, a tax should be imposed on transfers of property at least once each generation. If a given amount of wealth is, under one family arrangement, subjected to the transfer tax on three occasions over a one-hundred year period and another family's wealth of equal amount is taxed only once every hundred years, the two family accumulations are treated inequitably as compared to one another. While complete equity in the frequency of imposition is not achievable in a transfer tax based in part on transfers at death, fairness requires some approximation of equivalence.

Second, if transfers are not taxed each generation, it is also difficult to achieve progressivity, which is a form of vertical equity. Usually, only very large estates can make transfers that skip generations, i.e., that transfer wealth from grandparents to grandchildren. It is likely that the smaller estates generally cannot make such transfers because intervening generations will need the principal. Since the tax-saving possibility in generation-skipping transfers ("GSTs") increase as the estate becomes larger, such transfers may reduce or eliminate progressivity.

Finally, the opportunity to avoid transfer tax through GSTs creates an incentive to dispose of property in a tax-minimizing manner. The transfer tax system should intrude as little as possible on non-tax decisions with respect to the form chosen to transmit wealth. A tax preference for GSTs creates an incentive to use tax-minimizing forms of disposition even if the transferor's property would be transferred in a different way absent the tax benefits.

The generation-skipping tax is designed to redress these problems. As currently constructed, the GST tax is, in general, a flat 35 percent tax applied to all GSTs that cumulatively exceed the exemption amount of $5 million. This 35 percent tax applies in addition to any gift or estate tax that may also apply to the transfer. The result is that a taxable gift or bequest that skips a generation, such as to a grandchild, may very well be subject to the regular transfer tax of 35 percent *and* the GST tax of 35 percent to the extent that current and prior GSTs exceed $5 million.

1. THE SITUATION PRIOR TO ADOPTION OF THE GST TAX

Prior to the adoption of the GST tax in the Tax Reform Act of 1976, wealthy transferors could easily avoid the imposition of the transfer tax for one or more generations. For example, if an individual had a taxable estate of $10,000,000 and left it outright to her two children equally, the estate tax under the rates then applicable would have been about $6,000,000 and each of her children would have received $2,000,000. Assuming that the children then lived on the income from their inheritances without consuming principal, each of their estates would have paid an estate tax of about $750,000 when the property passed to their children, so that the latter would, in total, have inherited $2,500,000 of their grandparent's wealth. On the other hand, the grandparent could have left her estate in trust, the income going to the children with the remainder to the grandchildren. Under this arrangement, her estate would still have paid an estate tax of $6,000,000, the same as in the first case, but the estate tax on the death of the children would have been avoided. The grandchildren would therefore have inherited $4,000,000 of that grandparent's wealth. The amount passing to the grandchildren would be over 50 percent greater in the second case than in the first, although the effect of the two transactions over the two generations was otherwise essentially the same.

This effect could be enhanced by using transfers that kept assets in trust for more than one generation and thereby avoided the transfer tax on more than one intervening death. But skipping one or more generations for estate tax purposes did not involve skipping generations as far as enjoyment of the assets was concerned. An intermediate beneficiary, while alive, could enjoy the income, control investments, obtain principal needed for her support, control the disposition of income and principal to persons other than herself, and even be able to withdraw the greater of $5,000 or 5 percent of the principal annually during her lifetime—all without incurring estate or gift taxes except as to the amount of principal she could have withdrawn for herself at the moment of death, i.e., the greater of $5,000 or 5 percent of the principal. (See p. 358 of the Casebook for a discussion of the treatment of powers to withdraw the greater of $5,000 or 5 percent of principal.)

The techniques used by tax advisors to implement GSTs —and the resulting effects on tax equity—were graphically described in Casner, ESTATE AND GIFT TAX CHANGES, 103 Trusts and Estates 932 (1964). This classic article, part of which is quoted below, provides a very useful summary of estate planning devices we have discussed in prior chapters as well as a description of GSTs that prompted Congressional concern:

"In discussing a problem in connection with the drafting of wills which may lead to some consideration for change in the not too distant future, I would like to develop it by assuming a conversation that I might have had with a client who wanted to have his will made and said simply, 'I want a very simple will. I want the property to go to my son outright. I have complete confidence in him and in his ability to deal with it.'

"Let us assume that A is our client, aged 75, and S is his son, aged 50, and that the amount of the property that would reach S's hands after the tax debt has been paid would be $250,000. I pointed out to A that the income from this $250,000 will be taxed to S on top of whatever other income he may acquire, and that if S ever sells the property and it has appreciated in value, the capital gain will be taxed to S.

"I further pointed out to A that when his son dies, assuming that there has been no change in value and eliminating a number of other factors that might enter the picture, S would pay $65,700 in taxes to move this $250,000 to his child. Then if S's child on his death leaves the property outright to his child, the grandchild of S, there will be another $45,000 plus in taxes. As a result of following out this plan of outright giving, therefore, A's $250,000 would have decreased by somewhere around 45% by the time it reached S's grandchild.

'That realization shook A a bit and he asked, 'Is there any way we can arrange this to avoid this depreciation?'

"I said, 'Yes. It isn't necessary to pay that tax as the property passes from S to his child and then to the grandchild, if you don't want to. In your will we can transfer this $250,000 to a trustee to pay the income to your son for his lifetime. Then we can provide that on his death the trustee will pay the income to his child for life. We can further provide that on the death of the child the property will go outright to S's grandchild at whatever age we decide he should be able to get it into his hands.'

" 'Well,' A said, 'that is quite a different arrangement from what I had in mind. It is not at all similar to give my son just the income from the trust for life instead of the complete ownership.'

"I agreed with him but suggested we could modify this idea and still accomplish our goal. I said, 'First, suppose we put S in as the trustee. Now he has the property and he is managing it just as he would if he owned it outright. He would decide when to sell it and what to reinvest the proceeds in as he would if he owned it.'

"A said, 'That certainly helps, if it can be done and the result not changed. Is there any more you can do to get the plan a little bit more like what I had in mind when I came in?'

"I said, 'Yes. We can add a power in your son by his will to appoint the property in any way he wants, to anyone except himself, his estate, his creditors, and the creditors of his estate.'

"He said, 'You mean when he dies he can have practically the same control as to where the property would go on his death as if he owned it outright except that he just can't appoint it to his estate or creditors of his estate?'

" 'Yes, the law allows that.'

" 'Well,' A said, 'that is getting pretty close now to what I had in mind because I have a feeling that I would like my son to decide on his death where the property will go in the light of conditions that then exist, and he ought to be in a position to take it away from his children if they haven't shown him the proper parental affection, etc., just as he could if he owned it. Is there anything more you could do?'

" 'Yes,' I continued, 'We can give your son a power by deed, exercisable any time during his lifetime, to appoint this property to anyone but himself, his estate, his creditors, or the creditors of his estate. So that if, during his lifetime, he wants to give it to his children he can do so and not have to pay any gift tax. The *Self* case[1] held that this kind of power was a limited power to appoint and its exercise was not subject to gift tax. It is true that the Treasury Department does not agree with the case on one point and would contend that your son was at least making a gift of his life interest in the property that he has appointed.[2] However, this issue does not affect the saving of the tax on your son's death.'

" 'The only thing I see wrong with this now,' A remarked, 'is that you haven't provided for my son to get his hands on any of the money during his

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[1][Ed.: 142 F.Sup 939 (Ct.Cl.1956). The *Self* case is discussed at page 376 of the Casebook.]

[2][Ed.: The Tax Court adopted the Treasury's view in Regester v. Commissioner, 83 T.C. 1 (1984). The *Regester* case is discussed at page 376 of the Casebook.]

lifetime if he should need the principal, which he could do if I gave it to him outright.'

" 'Well,' I said, 'we can do something about that without changing our estate tax result. We can give your son a power to invade the corpus during his lifetime to any extent that may be necessary for his health, education, support, or general maintenance. The law says he can have that kind of power and, when he does what is left will pass on without any delay. So, if he doesn't need the principal as long as he lives, it will be there, and we will save this $65,000 which otherwise we would have to pay if we gave it outright as you first suggested.'

" 'Well,' A went on, 'that is amazing. Now, is there anything more we can do because I would like my son to be able to get his hands on the money if he wanted to without this standard that you have been talking about.'

" 'Yes,' I answered. 'We can give your son a power to withdraw annually $5,000 or 5% of the corpus, whichever is greater, and the mere existence of this power will upset our plans only to the extent that in the year in which he dies we will have to include in his estate for estate tax purposes the amount that was still withdrawable in that year. It would not be a tax on $250,000, but only on the $5,000 or 5% figure. And he can have that non-cumulative power every year to draw down that amount.'

" 'Well,' he said, 'that just about does it. That is just about what I had in mind. Is there anything more that you might like to suggest to me?'

" 'Yes. It may be that your son will get into a position where he needs more than $5,000 or 5%, whichever is greater. So we can put in as another trustee, along with your son, a person who has no interest under the trust and we can give that trustee the power to pay him the whole principal any time he wants to, in his uncontrolled discretion.'

"He said, 'Can we pick who the trustee will be?'

" 'Yes, we can pick the trustee. The only thing is that he must approach his job honestly and not agree ahead of time what he is going to do

and he must not have an interest under the trust. We are not involved here with the so-called related and subordinate trustee problem, which comes up only in connection with the taxation of income to the creator of a trust while such creator is alive.'

"So he said, 'I think that would be a good idea. We have confidence in So-and-So. We will put him in as a co-trustee and give him the power to pay the principal over and above the $5,000 or 5% without regard to the standard you mentioned if that trustee in his uncontrolled discretion decides that the principal should be paid to my son.'

"Virtual Ownership

"The purpose of going through this story is to show how close, under present law, you can come to what the client has in mind of giving the property outright to his son and yet save the $65,000 that otherwise would go in taxes on the son's death. In a situation of this sort it is difficult to justify spending the $65,000 when you can do all these things under present law and come that close to total ownership.

"We can provide, of course, that in default of the exercise of these powers by S the trust will go for his child and we can set up the same powers for his child, so that when he dies, the property can go on to the grandchild, thus saving the $45,000 that otherwise would be paid in taxes at that time. And we can keep on doing this, for the grandchild, for the grandchild's child, and on and on, if you are in Wisconsin, which has no rule against perpetuities as to certain kinds of arrangements.

"Even in any other state that is governed by the common law rule against perpetuities, we can have the arrangement continue until 21 years after the death of the survivor of ten healthy babies selected from families of good longevity, so that we can be fairly certain the trust will be operating, before the property falls into the hands of someone outright, for as much as 100 years or more, and even then the fund won't be subjected to an estate tax until the one into whose hands it finally falls dies, which may be 40 or 50 years later.

"In other words, the estate and gift tax law that we now have in effect says, 'You can pay the tax or not, as you please, for a period of 100 to 150 years.' Those who choose to pay it oftener are doing so by setting up arrangements that are not greatly different from the arrangement they can set up within the tax-exempt area that the law permits." (932–33)

As the materials in this chapter are considered, determine the extent to which the plan developed by Professor Casner can be utilized after the enactment of the tax on GSTs and in what ways it must be modified. As another matter, if you represented S in the above situation, would you have any reason to object to the form of disposition recommended?

2. THE TAX REFORM ACTS OF 1976, 1986, 2001, and 2010

The techniques described by Professor Casner prompted Congress to adopt a GST tax in 1976. It was immediately the subject of withering criticism as special interest groups pressed for its repeal. In 1986 Congress repealed the 1976 legislation retroactively to its inception and enacted an entirely new tax on GSTs that simplified Chapter 13 and broadened its application.

The 2001 Act repealed the GST tax for GSTs occurring after December 31, 2009. To comply with the Congressional Budget Act of 1974, the GST tax was to be restored to its 2001 level (55 percent tax, $1 million exemption) for decedents dying after December 31, 2010. The repeal in 2010, and potential reinstatement of the GST tax in 2011 at its 2001 levels, caused complicated estate planning issues in 2010 and substantial uncertainty regarding the future of the tax. To avoid a return to the 2001 GST tax regime, Congress passed the 2010 Act, which extended the major provisions of the 2001 Act through December 31, 2012 and set the GST tax rate at 35 percent and the exemption at $5 million. Barring additional Congressional action, the GST tax will return to its 2001 level (55 percent tax, $1 million exemption) on January 1, 2013.

SECTION B. TRANSFERS SUBJECT TO THE GST TAX

INTERNAL REVENUE CODE: §§ 2601; 2611; 2612; 2613; 2651; 2652

REGULATIONS: § 26.2612-1

It is important to remember that the tax on a GST is assessed in addition to the estate or gift tax. For example, as discussed in more detail below, a taxable gift to a grandchild may generate not only a gift tax calculated using the applicable gift tax rate, but also a GST tax using the maximum transfer tax rate. Similarly, a bequest may be subject to both the estate tax and GST tax. As a result of a generous exemption, each taxpayer may make cumulative transfers of up to $5 million that skip generations before a GST tax will be incurred, although, as we will see, operation of the exemption is complex. Needless to say, estate planners devote a great deal of care to insuring that transfers are not subject to the GST tax.

Since § 2601 imposes a tax on a "generation-skipping transfer," the starting point is to determine whether a "generation-skipping transfer" has occurred. Section 2611 defines a "generation-skipping transfer" by describing three forms of transfers that skip over a generation: (1) the "direct skip" (2) the "taxable termination" and (3) the "taxable distribution." In the examples throughout this Chapter, "D" refers to the transferor, "S" refers to the transferor's spouse, "C" refers to a child of the transferor, "GC" refers to a grandchild of the transferor, and "GGC" refers to a great-grandchild of the transferor.

1. THE DIRECT SKIP

A direct skip is a transfer of an interest in property to a "skip person" that is subject to the gift tax or estate tax. § 2612(c)(1). A "skip person" is a person who is assigned to a generation that is two or more generations below that of the transferor pursuant to § 2651. § 2613(a)(1). The "transferor" is the donor in the case of an inter vivos gift of the decedent in the case of a testamentary transfer. § 2652(a). Thus, a transferor's gift or bequest to her GC is a direct skip because GC is a skip person. That is, GC is two generations below the transferor.

A skip person also includes a trust if the only persons with "interests" in the trust are skip persons. § 2613(a)(2)(A). For example, a transfer to a trust whose sole beneficiary is the transferor's GC is a direct skip because the only person with an "interest" in the trust is a skip person. In determining who has an "interest" in a trust, future interests are generally ignored. Section 2652(c)(1)(A) states that a "person has an interest in … a trust if … such person … has a right (*other than a future right*) to receive income or corpus from the trust." (emphasis added). This means that a trust that has only skip persons as present beneficiaries and non-skip persons as future beneficiaries will normally be treated as a skip person because the future interests held by non-skip persons are disregarded.[3] For example, a direct skip is deemed to occur when D transfers property to a trust from which income will be paid to GC for ten years and the corpus will then be distributed to C. Since C's interest in the trust is a future interest that is ignored, the only person holding an interest in the trust is GC, a skip person.

A trust is also a skip person if no person holds an interest in the trust and at no time after such transfer may a distribution be made from such a trust to a non-skip person. § 2613(a)(2)(B). Suppose that when GC is age 10, D creates a trust which will accumulate income until GC is age 21 and will then distribute the income and principal to GC, or to GC's estate if she dies before reaching age 21. GC's right to receive income and principal when she reaches age 21 does not constitute an "interest" under § 2652(c)(1)(A) because, as discussed above, most future rights to receive income or corpus from the trust are disregarded. Moreover, GC is a skip person. The trust is treated as a skip person because neither GC nor anyone else is deemed to have an interest in the trust and no trust distribution may be made to a non-skip person.

[3] One type of future interest that is not disregarded is a future interest held by a charity in a charitable remainder trust. § 2652(c)(1)(C). Thus, if D transfers property to a charitable remainder trust from which income will be paid to GC and the remainder to a qualifying charity, a direct skip has not occurred because the charity's remainder interest qualifies as an "interest" in the trust.

2. THE TAXABLE TERMINATION

Section 2612(a)(1) defines a "taxable termination" as the termination of an interest in property held in trust *unless* either:

> "(A) immediately after the termination, a non-skip person has an interest in the property, or
> (B) at no time after such termination may a distribution (including distributions on termination) be made from such trust to a skip person."

This definition, particularly subparagraph (B), is difficult to follow because it is stated in the form of a double negative. It is far more helpful to rearrange the definition to eliminate the double negative:

> A taxable termination is the termination of an interest in a trust, if two requirements are met:
> 1. Immediately after the termination no non-skip person has a present beneficial interest[4] in the trust; and
> 2. At least one skip person is or could be a beneficiary of the trust.

To see how this definition operates, consider a situation in which D transfers property in trust, income to C for life, remainder to GC. Since a non-skip person, C, has an interest in the trust, a direct skip has not occurred upon the creation of the trust. When C dies, however, and the trust distributes the corpus to GC, a taxable termination occurs. C possessed an "interest in property held in trust" as defined in § 2652(c)(1)(A) and her interest in the trust terminated at her death. The termination of this interest upon her death is a taxable termination if (1) immediately after the termination no non-skip person has a present beneficial interest in the trust and (2) at least one skip person is or could be a beneficiary of the trust. Since the only person having

[4] Note that in our restatement of this rule we say "present beneficial interest" in the trust instead of just "an interest" in the trust. Recall that, as discussed above, an "interest" in a trust generally includes only present beneficial interests. § 2652(c)(1)(A).

an interest in the property after the termination is GC, a skip person, requirement (1) is satisfied. Moreover, requirement (2) is satisfied since after the termination GC, a skip person, holds a beneficial interest, the remainder interest, in the trust.

Consider another example where D transfers property in trust, income payable jointly to D's children, C_1 and C_2, while both live, with all income then payable to the survivor, and upon the survivor's death, remainder to D's grandchild, GC. The creation of the trust is not a direct skip because the trust is not a skip person as a result of non-skip persons, C_1 and C_2, having interests in the trust. The subsequent death of C_1 is not a taxable termination because C_2, a non-skip person, has an interest and, therefore, requirement (1) is not satisfied. Upon the death of C_2, however, a taxable termination will have occurred because both requirements (1) and (2) are satisfied. Requirement (1) is now satisfied because no non-skip person has an interest in the trust. The only interest in the trust is held by a skip person, GC. In addition, requirement (2) is satisfied since GC, a skip person, holds a beneficial interest in the trust.

2. THE TAXABLE DISTRIBUTION

Section 2612(b) defines taxable distribution as "any distribution from a trust to a skip person (other than a taxable termination or a direct skip)." Suppose that D irrevocably transfers property in trust, income to C for life, remainder to GC and that D also gives the trustee discretion to distribute up to one-half the income to GC during C's life. The transfer to the trust is not a direct skip since C, a non-skip person, has an interest in the trust. What happens when the trustee distributes some income to GC? A direct skip has not occurred because the distribution of income to GC is not a transfer subject to the estate or gift tax as required by § 2612(c). (The irrevocable transfer of the property into the trust was the transfer subject to the gift tax. See Reg. § 25.2511-2(b), (c) and (d).) Moreover, a taxable termination has not occurred because C's interest in income has not been terminated.[5] However, a taxable

[5] It could be argued that the distribution of income to GC terminates C's interest in that income and, therefore, that a taxable termination has also occurred with respect

distribution has occurred since the trust distributed income to GC and § 2612(b) defines a taxable distribution as "any distribution from a trust to a skip person (other than a taxable termination or a direct skip)."

By describing a taxable distribution as "any distribution … (other than a taxable termination or a direct skip)," § 2612(b) makes clear that the rules applicable to taxable terminations and direct skips take precedence over taxable distributions. For example, suppose that D transfers property in trust, income to C for life, remainder to GC. D's transfer to the trust is not a direct skip because C, a non-skip person, has an interest in the trust. The distribution to GC upon C's death could be described as a taxable termination[6] or a taxable distribution, but the language of § 2612(b) makes clear that classification as a taxable termination applies. Giving precedence to taxable terminations over taxable distributions is important because, as discussed in the next sections, different persons are liable for the GST tax depending on whether the transfer is a taxable distribution or termination (§§ 2603, 2662(a)(1)), different deductions are allowed in calculating the GST tax liability for taxable terminations and taxable distributions (§ 2621(a)(2) and § 2622(b)) and the alternate valuation date is available for a taxable termination occurring at an individual's death but not for taxable distributions (§ 2624(c)).

ILLUSTRATIVE MATERIAL

A. WHO IS THE TRANSFEROR

To determine whether a GST has occurred, it is important to identify the transferor. In general, the donor, in the case of a gift subject to gift tax,

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to that income. But such an analysis would nullify the concept of taxable distributions and, therefore, has not been adopted by the Regulations. See Reg. § 26.2612-1(f) Ex. 10.

[6] The distribution satisfies the requirements for a termination because (1) immediately after the termination no non-skip person has a present beneficial interest in the trust and (2) at least one skip person, GC, is a beneficiary of the trust.

and the decedent, in the case of a bequest of property subject to the estate tax, is treated as the transferor in a GST. § 2652(a)(1). If a married couple elects under § 2513 to split gifts, each spouse will be treated as a transferor of one half of the gift for purposes of the GST tax. § 2652(a)(2).

You may recall that the donee spouse or surviving spouse who receives qualified terminable interest property ("QTIP") (see p. 590 of the Casebook for a discussion of QTIPs) must include the fair market value of the property subject to the QTIP in her gross estate under § 2044 if she retains her interest until death. See p. 606 of the Casebook. Alternatively, if the donee or surviving spouse disposes of her QTIP while living, § 2519 treats her as having made a gift of the property subject to the QTIP. See p. 605 of the Casebook. Consistent with this approach, § 2652(a) generally treats the donee or surviving spouse in these circumstances as the transferor for GST purposes of the QTIP property.[7]

B. GENERATION ASSIGNMENTS

Section 2613(a) defines a skip person as a person who is assigned to a generation that is two or more generations below that of the transferor. Section 2651 creates two categories of persons in order to determine the generation. The first category applies to lineal descendants. Section 2651(b)(1) assigns a generation to an individual who is a lineal descendant of a grandparent of the transferor by "comparing the number of generations between the grandparent and such individual with the number of generations between the grandparent and the transferor." Similarly, § 2651(b)(2) assigns a generation to a lineal descendant of a grandparent of a spouse (or former spouse) of the transferor by "comparing the number of generations between such grandparent and such individual with the number of generations between such grandparent and such spouse." Spouses and former spouses of

[7] Section 2652(a)(3), however, allows the spouse who created the QTIP to elect to be treated as the transferor for purposes of the GST tax after the recipient-spouse's death. Estate planners refer to this election as the "reverse QTIP election". See pp. 7.28 to 7.29 in this Supplement.

the transferor are assigned to the transferor's generation. § 2651(c)(1). Thus, where D makes gifts to his GC, his spouse's GC from a previous marriage, and his grandnephew, all donees will be assigned to a generation two levels below D

The second category applies to persons who are not lineal descendants. Such persons are assigned to generations based on their age. An individual who is not more than 12 1/2 years younger than the transferor is assigned to the transferor's generation. § 2651(d)(1). An individual who is more than 12 1/2 years but not more than 37 1/2 years younger than the transferor is assigned to the first generation below the transferor. § 2651(d)(2). An individual who is more than 37 1/2 years but not more than 62 1/2 years younger than the transferor is assigned to the second generation below the transferor. § 2651(d)(3). An additional generation is assigned for each additional 25 year interval. Id.

Adopted children are included in the category of lineal descendants. § 2651(b)(3)(A). Thus, an adopted child will always be assigned to the generation immediately below the adopting parent regardless of the age difference. For example, if D adopts a child 40 years younger than she, the child will be assigned to the generation immediately below her although the age category would have assigned the child to the second generation below D.

C. CONTINGENT REMAINDER INTERESTS AS SKIP PERSONS

Suppose that D creates a trust, income to A for life and on A's death to accumulate the income until D's child, C, reaches the age of 40, at which time the accumulated income and principal will be distributed to C. If C dies before reaching age 40, the trust's assets are to be distributed per stirpes to C's descendants. What happens if A dies while C is 35 years old? Has a taxable termination occurred?

Recall that a taxable termination is the termination of an interest in a trust, if two requirements are met:

1. Immediately after the termination no non-skip person has a present beneficial interest in the trust; and
2. At least one skip person is or could be a beneficiary of the trust.

The first requirement is satisfied. Even though C, a non-skip person, is a beneficiary of the trust, he does not have a *present* "interest" in the trust because he will not be entitled to receive income distributions until age 40. § 2652(c). At first glance, the second requirement also appears to be satisfied. Distributions may be made to C's descendants, who are skip persons, if C dies prior to reaching age 40. However, Reg. § 26.2612-1(b)(1)(iii) states that the possibility of a distribution to a skip person will be disregarded if it can be ascertained by actuarial standards that there is less than a 5 percent probability that the distribution will occur. Thus, if there is less than a 5 percent chance that distributions will be made to C's descendants, the exception in § 2612(a)(1)(B) will apply and A's death will not be a taxable termination.

SECTION C. EXCEPTIONS TO GENERATION-SKIPPING TRANSFERS

There are some important exceptions to the general definition of direct skips, taxable terminations and taxable distributions.

1. DIRECT SKIPS

Predeceased Ancestor Exception. A gift or bequest by D to GC that is subject to transfer tax at a time that C, who is the parent of GC, is dead, is excluded from classification as a direct skip. § 2651(e)(1). For example, if D makes a gift to GC at a time that GC's parent, C, is dead, the gift will not be a direct skip and, therefore, will not be subject to the GST tax. This exception also includes transfers to collateral heirs if the transferor has no living lineal descendants at the time of the transfer. For example, suppose that D's nephew is deceased and that D makes a gift of property to her deceased nephew's child. The gift is not subject to the GST tax so long as D has no living lineal descendants at the time of the transfer.

Skips Over More Than One Generation. Section 2613 defines a skip person as a person assigned to a generation "which is two or more generations below" the transferor. Consequently, a gift by D to his great grandchild is subject to only one GST tax. Reg. § 26.2612-1(a)(1). This result conflicts with

the objective of the GST tax to assess a transfer tax on each generation, as discussed below at Supplement pp. 7.37 – 7.38.

Annual Exclusion Exception. An outright gift to an individual that qualifies as a direct skip is not subject to the GST tax if the gift qualifies for the gift tax annual exclusion under § 2503(b) or (e). § 2642(c).[8] Gifts in trust that are direct skips and which qualify for the gift tax exclusion are only excepted, however, if (1) the trust has only one beneficiary during that beneficiary's life and (2) the assets of the trust are includible in the beneficiary's estate if she dies before the trust terminates. § 2642(c)(2). For example, suppose D transfers $500 to an irrevocable trust for the benefit of GC, subject to GC holding a lapsing power of withdrawal (i.e., GC holds a *Crummey* power). The trust will pay income to GC for life and principal to her estate upon her death. The entire transfer is not subject to the GST tax under § 2642(c)(2) since it is a direct skip that qualifies for the annual exclusion.[9]

2. TAXABLE TERMINATIONS

Terminations Subject to Estate or Gift Tax. The regulations state that a taxable termination will not occur if the termination is itself subject to the estate or gift tax. Reg. § 26.2612-1(b)(1)(i). In that situation, the transfer instead will normally be treated as a direct skip or as a taxable distribution. For example, suppose D transfers property in trust, income to spouse S for life, remainder to GC, and a QTIP election (see p. 590 of the Casebook for a discussion of QTIPs) is made for the trust. S's subsequent death might appear to result in a taxable termination because it terminates her interest in the trust, no non-skip person has a present beneficial interest in the trust, and at least

[8]Section 2642(c) provides this exception by adjusting the formula for calculating the tax rate applicable to direct skips such that a zero rate is applied. The formula is discussed at p. 7.32 of this Supplement, infra.

[9] Arguably, GC could be treated as the transferee for GST purposes by virtue of the *Crummey* power. Section 2612(c)(3) makes clear that D, not the *Crummey* power holder, is the transferee. See Reg. § 26.2612-1(f) Ex. (3).

one skip person (GC) is a beneficiary of the trust. See § 2612(a)(1). The Regulations (Reg. § 26.2612-1(b)(1)(i)) dictate, however, that no taxable termination occurs because S's gross estate includes the QTIP principal under § 2044. See p. 591 of the Casebook. S's death instead results in a direct skip because S is treated as the transferor, Reg. § 26.2652-1(a)(1), of the trust property to a skip person, GC, that is subject to the estate tax. § 2612(c)(1). Reg. § 26.2612-1(f) Ex. (5).

Partial Terminations. Section 2612(a)(2) treats certain distributions as terminations. Suppose that D creates a spray trust such that trustee has discretion to pay income to C_1 and C_2, and their descendants. On the death of the first child, one-half of the trust principal is to be distributed to that child's living descendants per stirpes and the other one-half of the trust principal stays in trust until the surviving child's death. If C_1 dies first and one-half of the trust principal is distributed to C's children, under § 2612(a)(1) no taxable termination has occurred because a non-skip person, C_2, has an interest in the trust. Instead, but for § 2612(a)(2), the distribution would be a taxable distribution under § 2612(b). Section 2612(a)(2), however, treats such a distribution as a taxable termination, which trumps classification as a taxable distribution. § 2612(b).

Simultaneous Terminations. Suppose that C and GC have an interest in the trust that terminates at the same time and the trust principal passes to GGC. Have two taxable terminations occurred? Reg. § 26.2612-1(b)(3) states no; only one taxable termination occurs. Similarly, suppose that D transfers property to a spray trust in which trustee has discretion to pay income to C or GC, and that on C's death, the trust principal goes to GGC. On C's death, Reg. § 26.2612-1(b)(3) holds that only one taxable termination occurs, although both C's and GC's interests have terminated. This creates an odd result that conflicts with the objective of assessing a transfer tax on each generation, but which is consistent with the treatment of skips over more than one generation discussed immediately below. Note that if the trust had continued for GC's life, a taxable termination would have occurred on C's death, and another on GC's death.

Skips Over More Than One Generation. Similar to direct skips, a taxable termination that skips more than one generation is subject to only one GST

tax. Suppose D transfers property to trust, income to C, remainder to GGC upon C's death. Only one GST tax is assessed on C's death, although C's death triggers a taxable termination that skips over two generations (C and GC).

3. TAXABLE DISTRIBUTIONS

Skips Over More Than One Generation. As is the case with direct skips and taxable terminations, a distribution that skips multiple generations is subject to only a single tax. For example, suppose D creates a spray trust in which the trustee has discretion to distribute income to C, GC or GGC, with remainder to GGC. A distribution of income to GGC is a single taxable distribution even though two generations have been skipped.

The Move-Down Rule. Suppose that D transfers property to a trust for the benefit of GC and GGC. During GC's life, the trust income may be distributed to GC and GGC in the trustee's absolute discretion. The transfer to the trust was a GST, a direct skip, for which a GST tax would usually be assessed. § 2611. Subsequent distributions by the trust to GC should not be subject to additional GST tax. Section 2653(a) accomplishes this by providing that when a GST occurs and the property is held in trust after the transfer, the trust is treated as if the transferor were "moved down" to the first generation above the highest generation of any person who has an interest in the property immediately after the GST. This means that distributions to GC are not taxable distributions subject to the GST tax because § 2653(a) causes D to be "moved down" to a generation that is only one generation above GC. Distributions to GGC, however, are taxable distributions, since D is still two generations above GGC after the "move down." See Reg. § 26.2653-1(b) Ex. 1.

SECTION D. CALCULATING THE GST TAX

INTERNAL REVENUE CODE: §§ 2602; 2603; 2621; 2622; 2623; 2624; 2515

The amount of the GST tax is the product of the "applicable rate" and "taxable amount". § 2602. If no exemption is applied to a GST, the applicable rate is the maximum federal estate tax; there is no graduated rate structure for GSTs. The "taxable amount" varies, depending upon the type of GST that has occurred. This section discusses calculation of the GST tax assuming a 35%

applicable rate, the current maximum federal estate tax rate. Situations where the applicable rate is adjusted downward because of the GST exemption are discussed in Section E.

1. DIRECT SKIPS

In a direct skip the taxable amount is the value of property received by the transferee. § 2623. The tax is paid by the transferor or, in the case of a transfer from a trust, the trustee. § 2603(3).[10] The taxable amount in a direct skip does not include the GST tax, itself. Thus, the GST tax for direct skips is calculated on a GST tax exclusive basis. Section 2515, however, treats the amount of the GST tax as an additional taxable gift where the direct skip is a gift.

For example, suppose D gives $1 million to GC in 2011. The taxable amount is the $1 million received by GC. The GST tax, assuming an applicable rate of 35%, is $350,000, which D will be liable to pay. In addition, D will have to pay a gift tax on the transfer. Assuming a gift tax rate of 35% with no available exclusions or unified tax credit, D's gift tax liability will equal $ 472,500 (35% times $1 million gift plus 35% times the GST tax of $350,000). D has incurred a total tax liability of $ 822,500 ($350,000 GST tax plus $472,500 gift tax) as a result of the transfer. Thus, the total amount needed to transfer $1 million to GC in the form of an inter vivos gift is $1,822,500.[11]

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[10]Direct skips that involve "trust arrangements", are subject to a special rule in Reg. § 26.2662-1(c)(2). If the direct skip involves less than $250,000, occurs at death and involves a trust arrangement, the executor of D's estate, not the trustee, must pay the GST tax. The executor is entitled to recover the tax from the trustee or the recipient of the property.

[11]This is equal to the amount with which D would have started had D made a taxable gift to C and then C made a taxable gift to GC. If D had started with $1,822,500, he could have made a gift of $1,350,000 to C and paid a gift tax of $472,500. C would then have made a gift of $1,000,000 to GC and paid a gift tax of $350,000.

Section 2515 attempts to equalize the effect of a direct skip by gift with one by bequest. This attempt is only partially successful. Since the estate tax is tax inclusive, the estate tax is computed on all estate assets, including those used to pay the estate tax and GST tax. Section 2515, in contrast, causes the gift tax to become tax inclusive only to the extent of the amount used to pay the GST tax.

In the above example involving an inter vivos gift, D needed to start with $1,822,500 in order for GC to have $1 million after paying the gift tax and GST tax. How large must D's taxable estate be for GC to receive $1 million after the federal estate tax and GST tax are paid, assuming that no unified credit is available and that the estate tax rate is 35 percent? The answer is $2,076,923.08, as shown below.

Taxable estate	$2,076,923.08
less estate tax	- ($726,923.08)
	$1,350,000.00
less GST tax	-($ 350,000.00)
Amount to GC	$1,000,000.00

The difference between the $2,076,923.08 outlay for a GST bequest and the $1,822,500 outlay for a gift is attributable to the fact that the gift tax is tax exclusive. Although § 2515 requires the gift tax base to include the GST tax, the gift tax base does not include the amount used to pay the gift tax itself. In contrast, the estate tax base includes the entire amount used to pay the estate tax as well as the GST tax.

Although § 2515 applies only to gifts, bequests have their own anomaly. Section 2603(b) directs that the GST tax be charged directly to property comprising the GST unless the governing instrument (e.g., D's will) directs otherwise by specific reference to the GST tax. For example, suppose that D wishes to leave $1 million to GC, and that D's will is silent as to the source of payment of the GST tax. Assume that no unified credit remains, that the estate tax is paid from other bequests, and that the applicable rate for GST purposes is 35%. D's bequest to GC would have to be $1,350,000 in order for GC to have $1,000,000 after payment of the GST because § 2603(b) mandates payment of the tax from the bequest. Note that the amount of the

bequest and the GST tax are interdependent in this example—the taxable amount (i.e., the amount received by GC) is dependent on the amount of the GST tax, which is in turn dependent on the amount received by GC. The formula to calculate the GST tax in this situation is:

GST tax = .35 x (bequest - GST tax)

This in turn becomes:

GST tax = (.35/1.35) x (bequest)

In this example, the bequest of $1,350,000 multiplied by .35/1.35 results in a GST tax of $350,000.

If D's will had specifically required payment of the GST tax from other sources, the bequest need only be $1 million to GC. § 2603(b). Note, however, that regardless of the requirement in the will, the GST tax for a transfer of $1 million to GC is the same—$350,000. The reference in the will to payment of the GST tax only affects the source of the GST tax payment.

2. TAXABLE TERMINATIONS

The taxable amount in a taxable termination is the value of all property with respect to which the taxable termination has occurred less deductions similar to those allowable under § 2053. § 2622(a). Note that this amount includes the GST tax liability itself and, therefore, the tax on taxable terminations is tax inclusive. The treatment of taxable terminations is thus similar to the treatment that would have occurred had the property been transferred outright to the skipped generation and then included in the skipped generation's taxable estate.

The GST tax in the case of a taxable termination is payable by the trustee. The alternate valuation date provided by § 2032 is available for purposes of determining the value of a taxable termination that occurs "at the same time as and as the result of the death of an individual." § 2624(c).

To illustrate the computation for taxable terminations, consider a situation where D transfers $1,538,461.54 inter vivos to a trust, income payable to C for life, remainder to GC. Assume that the unified credit and annual exclusion are not available and that D's gift tax rate and the applicable rate are both 35%.

Upon the transfer, D incurs a gift tax liability of $538,461.54 (35% x $1,538,461.54) which he pays from other sources. At C's death, a taxable termination occurs. Assuming that the trust res is $1,538,461.54, the trustee will pay a GST tax of $538,461.54 (35% x $1,538,461.54) out of the trust res leaving GC with $1 million. The total outlay by D required to transfer $1,000,000 in this format to GC is $2,076,923.07. This is the same outlay that was required for a direct skip in the form of a bequest illustrated on p. 7.21 of this Supplement.

If D creates a testamentary trust with the same terms, the total outlay would increase to $2,366,863.91. The estate tax on $2,366,863.91 is $828,402.37, leaving $1,538,461.54 to pass to the trust. The taxable termination on C's death results in a GST tax of $538,461.54, leaving $1 million for GC. The total outlay for the testamentary trust is higher than the inter vivos trust because the gift tax is tax exclusive.

3. TAXABLE DISTRIBUTIONS

The taxable amount in a taxable distribution is the amount received by the transferee reduced by expenses she incurs in connection with the determination, collection or refund of the GST tax imposed on the taxable distribution. § 2621(a). It may appear that since the GST tax is imposed on the amount received by the transferee, the GST tax on taxable distributions is tax exclusive like the tax on direct skips. However, unlike direct skips, where the transferor is liable for the GST tax, the transferee is liable for the GST tax on taxable distributions. § 2603(a)(1). This means that the GST tax on taxable distributions is tax inclusive, i.e., the amount which will be used to pay the GST tax is included within the GST tax base.

To illustrate, suppose that D transfers $1,538,461.54 to a spray trust, income and principal payable to C and GC at the discretion of the trustee (T),

remainder to GCC. D incurs a gift tax of $538,461.54 (35% x $1,538,461.54). If T distributes $1,000,000 to GC, GC will pay a GST tax of $350,000 leaving GC with $650,000.[12]

SECTION E. THE GST EXEMPTION AND THE APPLICABLE RATE

INTERNAL REVENUE CODE: §§ 2631; 2632; 2641; 2642(a)-(d), (f)

REGULATIONS: § 26.2632-1; § 26.2642-1

1. OVERVIEW

Every individual is allowed a GST exemption to allocate among inter vivos and deathtime GSTs to individuals and trusts that are direct skips and to trusts that are not direct skips. § 2631(a) and (c). The GST exemption equals the exclusion amount for the estate tax unified credit. In 2011 and 2012 this amount is $5 million, except that the 2012 exemption will be indexed for inflation. In 2013, the exclusion amount will drop back to $1 million, the exclusion in 2001, with an adjustment for inflation.

As discussed below, the allocation of all or a portion of the exemption to a particular transfer determines the "applicable rate", i.e. the tax rate applicable to the generation skipping transfer. For example, if in 2011 D allocates her entire $5 million exemption to a $5 million gift to GC, the applicable rate is zero, and therefore the GST tax is zero. Allocations of the exemption to transfers in trust can have an even greater impact. For example, if D transfers $1 million to a trust of which C is the income beneficiary and GC is the remainder person and D allocates $1 million of her GST exemption to that transfer, no GST tax will be paid upon the termination of the trust—even

[12]Note that if T had distributed the entire trust res of $1,538,461.54, both a taxable distribution and taxable termination will have occurred. See Reg. § 26.2612-1(f) Ex. (7). In that situation, as discussed above, the rules for taxable terminations apply. § 2612(b).

if the trust principal has grown to $50 million. The policy aspects of the exemption are discussed at below.

The applicable rate encompasses the GST exemption in an algebraic formulation. The applicable rate is the maximum federal estate tax rate in effect at the time of the transfer multiplied by the "inclusion ratio." § 2641(a). The inclusion ratio is equal to 1 minus the "applicable fraction." § 2642(a)(1). The applicable fraction is the amount of the GST exemption allocated to the transfer divided by the value of the property transferred.[13] § 2642(a)(2).

For example, suppose that in 2011 D transfers $1,500,000 to a trust, income to GC for life, then remainder to GGC. A GST has occurred at this moment because no non-skip person has an interest in the trust. If D allocates $1.5 million of his GST exemption, the applicable fraction is 1 ($1.5 million divided by $1.5 million). The inclusive ratio is zero (1 minus 1). The applicable rate is, therefore, zero (35% multiplied by zero). Thus, no GST tax will be due.

Alternatively, if D allocates $300,000 of his GST exemption to the transfer, the applicable fraction is 1/5 ($300,000 divided by $1.5 million). The inclusion ratio is 4/5 (1 minus 1/5). The applicable rate is therefore 28% (4/5 x 35%) and the GST tax is $420,000.

2. ALLOCATION OF THE GST EXEMPTION

A transferor of property may allocate her GST exemption to transfers that are direct skips (to trusts or otherwise) or transfers to trusts that are not direct skips. See § 2631(a). In general, an individual may choose to which of these transfers the exemption will be allocated. An allocation to GSTs, other than direct skips that are inter vivos gifts, may be made by an individual (or his executor) at any time on or before the due date of the transferor's estate tax

[13] The value of the transferred property is reduced by any federal estate or state death taxes attributable to the property that is recovered from a trust and any charitable deductions allowed with respect to the property. § 2642(a)(2).

return (regardless of whether a return is actually required). § 2632(a)(1). Once an allocation is made it is irrevocable. § 2631(b).

In some situations, a transferor is deemed to have made an allocation unless she expressly elects otherwise. If the transfer is an inter vivos direct skip, any unused portion of the transferor's exemption (up to the amount of the transfer) will be deemed allocated to the direct skip unless the transferor elects otherwise in a filing on or before the date a gift tax return for the transfer would have to be filed. § 2632(b). Reg. § 26.2632-1(b)(1). The unused portion of the transferor's exemption is that portion of the exemption that has not been allocated by the transferor to prior transfers or deemed allocated by the transferor to a prior inter vivos direct skip. Also, if a transferor makes an inter vivos transfer that is not a direct skip to a trust and that trust may subsequently make a taxable distribution or experience a taxable termination, the transferor is deemed to have allocated any remaining exemption to the transfer unless he elects otherwise. § 2632(c). Any remaining exemption, which is not allocated on or before the estate tax return due date, is deemed allocated to direct skips occurring at death and all trusts with respect to which a taxable distribution or termination might occur at or after the transferor's death. § 2632(e)(1).

A married couple has two GST exemptions. The exemptions are *not* freely transferable between the spouses and the unused exemption of one spouse cannot be aggregated with the remaining exemption of the other. However, married individuals may elect § 2513 gift-splitting treatment for inter vivos generation skipping transfers and, therefore, in effect share their exemption. § 2652(a)(2). Also, in the case of QTIP transfers, the transferor spouse or her executor may elect to be the transferor of the property for purposes of the GST tax even though the property will be included in the tax base of the transferee-spouse for the estate and gift taxes. § § 2652(a)(3), 2044 and 2519. This election is frequently called the "reverse QTIP election."[14]

[14] Prior to 2004, the reverse QTIP election was often helpful because the GST exemption exceeded the unified credit exclusion amount. Most estate plans of the first spouse to die transfer to a QTIP trust (see p. 590 of the Casebook) all the first spouse's assets other than an amount equal to the unified credit exclusion amount.

3. THE APPLICABLE RATE

As discussed above at p. 7.25 of this Supplement, the applicable rate is equal to the maximum federal estate tax rate multiplied by the inclusion ratio. § 2641(a). To repeat the drill: the inclusion ratio is equal to 1 minus the applicable fraction. § 2642(a)(1). The applicable fraction is the amount of the GST exemption allocated to the transfer divided by the value of the property transferred. § 2642(a)(2). For example, if D transfers $1,500,000 to her grandchild and allocates $500,000 of her GST exemption to the transfer, the applicable fraction is 1/3 ($500,000 GST exemption divided by $1,500,000 transfer.) The inclusion ration is then 1 minus the applicable fraction of 1/3, which is 2/3. As a result, the applicable rate is 23.33% (35% multiplied by the inclusion ratio of 2/3).

An amount equal to the unified credit exclusion amount is transferred to a non-marital trust for the benefit of children or grandchildren. Without the reverse QTIP election, the first spouse would be unable to allocate to the QTIP trust the portion of the GST exemption that exceeded the unified credit exclusion amount transferred to the non-marital trust. For example, in 2002 the GST exemption amount was $1.1 million while the unified credit exclusion amount was $1 million. Suppose that upon D's death in 2002, she transferred $1,000,000 (the applicable unified credit exclusion amount) to a non-marital trust, income to C for life, remainder to GC. D allocated $1,000,000 of her $1,100,000 GST exemption to this transfer. She transferred her remaining assets in a QTIP trust, income to her surviving spouse, remainder to GC. Without the reverse QTIP election, the remaining $100,000 of D's GST exemption would be unused. With a reverse QTIP election by D's executor, D's estate can allocate her remaining $100,000 GST exemption to the QTIP trust so that the QTIP trust will benefit when the surviving spouse dies.

The reverse QTIP election is less useful for transfers occurring after 2003 because the GST exemption equals the unified credit exclusion amount. This parity allows the first spouse to allocate her entire GST exemption to the non-marital trust. For example, in 2011 D would likely transfer $5 million (the unified credit exclusion amount) to the non-marital trust for C and GC and allocate her entire $5 million GST exemption to the transfer. Since she has allocated her entire $5 million GST exemption to the non-marital trust, a "reverse QTIP election" would not help the marital trust.

The inclusion ratio is determined at the time some portion of the transferor's exemption is allocated to the transfer. § 2642(b). Where the allocation is made on a timely filed gift tax return or is deemed allocated under § 2632(b) or (c), the gift tax value is used to determine the inclusion ratio. § 2642(b)(1). If, on the other hand, the allocation is not made on a timely filed gift tax return, the inclusion ratio will be determined by reference to the value of the property at the time the allocation is made. § 2642(b)(3). If property is transferred at or after the transferor's death, the estate tax value is usually the value to be used to determine the inclusion ratio.[15] § 2642(b)(2). If the beneficiary of a QTIP interest is treated as the transferor, the estate tax value of the property included under § 2044 is used to determine the inclusion ratio. § 2642(b)(4).

Once the inclusion ratio is determined for a trust, that ratio is used to calculate the applicable rate to be applied to all subsequent taxable distributions and terminations of the trust so long as no further transfers to the trust occur. See Reg. § 26.2642-1(b)-(c) and (d) Ex. (1) and (2). Since D may allocate her exemption to transfers into trusts that are not direct skips and since the inclusion ratio is also determined at that time, an opportunity to save significant GST taxes arises.

For example, suppose in 2011 D transfers $5 million into a trust, income to C for life, remainder to GC, and that she allocates her entire $5 million GST exemption to the transfer in a timely-filed gift tax return. Since the inclusion ratio calculated at that time is zero (1 minus $5 million/$5 million), the applicable rate applied to subsequent GSTs from the trust will be zero. If, at the time of C's death, the trust principal is $10 million, that $10

[15]One exception is that qualified real property for which the special use § 2032A election (see p. 786 of the Casebook) is made is valued for GST tax purposes under § 2032A so long as the recapture agreement described in § 2032A(d)(2) provides that the signatories are personally liable for the recapture of GST tax. Reg. § 26.2642-2(b)(1). Another exception is for the payment of pecuniary bequests with property other than cash. Reg. § 26.2642-2(b)(2) and (3).

million passes to GC with no concurrent GST tax liability (or, for that matter, estate tax liability). Where the applicable rate is zero, all appreciation occurring subsequent to the transfer to the trust is shielded from the GST tax.

The applicable fraction and inclusion ratio must be recomputed if additional property is transferred to a trust after some portion of the transferor's exemption has already been allocated to it. § 2642(d)(1). The numerator of the recomputed applicable fraction is the sum of the exemption allocated to the later transfer plus the "non-tax portion" of the trust immediately before the transfer. § 2642(d)(2). The "non-tax portion" of the trust is the product of the value of all the property in the trust immediately before the transfer and the applicable fraction in effect for the trust before the transfer. § 2642(d)(3). The denominator is the sum of the value of the property involved in the later transfer (reduced by federal estate and state death taxes paid by the trust with respect to such property and by any charitable deductions allowed with respect to the transfer) and the value of all the property in the trust immediately before the transfer. Id.

For example, assume that A transferred $1 million to a trust and allocated $500,000 of his GST exemption to the trust. The applicable fraction with respect to the trust is 1/2 (and the inclusion ratio is 1/2). When the trust corpus appreciates to $4 million, the non-tax portion of the trust is $2 million ($4 million multiplied by applicable fraction of 1/2). Suppose that A then transfers an additional $3.5 million to the trust and allocates another $500,000 of GST exemption to the trust. The numerator of the new applicable fraction is $2.5 million (the $500,000 exemption allocated to the second transfer plus $2 million—the non-tax portion of the trust immediately before the transfer). The denominator of the new applicable fraction is $7.5 million (the value of the trust immediately before the transfer—$4 million—plus the amount of the subsequent transfer—$3.5 million). The new applicable fraction is 1/3. The inclusion ratio is 2/3 and, therefore, the applicable rate for subsequent generation-skipping transfers will be 2/3 of the maximum tax rate at the time of such transfers.

As discussed at page 7.18 of this Supplement, an outright gift to individuals and certain transfers to trusts that qualify for the annual exclusion and that are direct skips are not subject to the GST tax under § 2642(c). The

mechanism by which this exclusion is achieved is through the inclusion ratio. Section 2642(c) assigns an inclusion ratio of zero for the qualifying transfers.

ILLUSTRATIVE MATERIAL

A. ESTATE TAX INCLUSION PERIOD

Section 2642(f) provides that where D transfers property that is includible in his gross estate after the transfer (other than by § 2035), D's allocation of his GST exemption cannot become effective until after the estate tax inclusion period ("ETIP"). Section 2642(f)(3) generally defines the ETIP as the period for which the transferred property would be includible in the transferor's estate, except that the ETIP terminates either when a GST with respect to the property occurs or the transferor dies. Note that the ETIP rule will often result in GST taxation of any appreciation in the transferred property that occurs during the ETIP period. For example, suppose in 2011 D transfers $500,000 to a trust, income to D, remainder to GC. D allocates $500,000, which is the remaining amount of his $5 million GST exemption, to the transfer. On D's death the trust res is valued at $1,000,000 and a taxable termination occurs. D's inclusion ratio is 1/2 because his $500,000 allocation exemption only became effective on his death. The regulations provide that an allocation made at the time of the transfer cannot subsequently be revoked even though it is not effective until D's death. Reg. § 26.2632-1(c)(1). D's executor may allocate any unused exemption to the property at the time of D's death. Reg. § 26.2632-1(d)(1).

The regulations expand the scope of § 2642(f) to apply where the transferred property would be included in the estate of the transferor's spouse if such spouse died after the transfer. Reg. § 2632-1(c)(2). Two important exceptions exist. First, property is not considered to be includible in the gross estate of the transferor's spouse for the ETIP rule if the spouse possesses only the right to withdraw not more than the greater of $5,000 or 5% of the trust corpus, and such withdrawal right terminates no later than 60 days after the transfer of the property in trust. Reg. § 26.2632-1(c)(2)(ii)(B). This is, in effect, a de minimis exception. Second, a QTIP for which the transferor has made a "reverse QTIP election" (see p. 7.27 of this Supplement), is not subject to the ETIP rule. Reg. § 26.2632-1(c)(2)(ii)(C).

B. NONTAXABLE TRANSFERS AND THE INCLUSION RATIO

The regulations address the manner for calculating the inclusion ratio in the case of nontaxable transfers. Reg. § 26.2642-1(c)(2) states that the denominator is reduced by the value of nontaxable property in the case of a direct skip. For example, if D makes a $13,000 cash gift to GC that qualifies for the annual exclusion, the denominator of the applicable fraction is zero with the result that the inclusion ratio is zero.[16]

Reducing the denominator to zero works when the entire transfer is nontaxable but fails when the transfer is partly taxable and nontaxable. Example (3) of Reg. § 26.2642-1(d) solves the problem by dividing the transfer into two parts. Suppose that D transfers $14,000 in an irrevocable trust, income to GC for ten years, remainder on GC's death to GC's estate. GC is given a *Crummey* power with respect to $5,000 so that $5,000 of the transfer qualifies for the § 2503(b) annual exclusion. Example (3) states that solely for computing tax on the direct skip (the transfer to the trust), the transfer is divided into two portions. One portion equals the amount of the nontaxable $5,000 transfer and is assigned a zero inclusion ratio.[17] The other portion of $9,000 is assigned a value of $9,000 for the denominator of its applicable fraction. If D has adequate GST exemption, the numerator is also $9,000 (unless D elects not to have her exemption apply). The result is that the applicable fraction for the $9,000 portion is 1 ($9,000/$9,000) and the inclusion ratio is zero (1 minus 1). Although Example (3) states that the approach of

[16]Reg. § 26.2642-1(c)(2) states that if the denominator of the applicable fraction is zero, then the inclusion ratio is also zero.

[17]Section 2642(c)(2) states that a direct skip to a trust for the benefit of an individual which is nontaxable under § 2503 is assigned a zero inclusion ratio where (A) during the life of the individual, no portion of the corpus or income of the trust may be distributed to (or for the benefit of) any person other than such individual and (B) the trust's assets are included in such individual's gross estate if the trust does not terminate before the individual dies.

using two portions applies "(s)olely for purposes of computing the tax on the direct skip," presumably the two inclusion ratios will also apply for the taxable termination that occurs on GC's death. See Reg. § 26.2632-1(a).

SECTION F. INTERRELATIONSHIPS OF GST TAX WITH ESTATE, GIFT AND INCOME TAXES

INTERNAL REVENUE CODE: §§ 2654; 2661

1. IN GENERAL

The GST tax interacts with a number of provisions in the estate, gift and income taxes. The following discusses the most important of those interactions.

Disclaimers. A disclaimer that results in property passing to a person at least two generations below the original transferor results in imposition of the GST tax. Thus, if D's child makes a qualified disclaimer and the disclaimed property passes to D's grandchild, a GST tax is imposed on the transfer. On the other hand, a qualified disclaimer by D's GC may prevent a GST tax. For example, if GC disclaims D's bequest so that the property will pass to C, the disclaimer will eliminate the GST tax.

Administrative Rules. In addition to the provisions of the estate and gift tax that have been incorporated in the generation-skipping tax and discussed above, the administrative provisions of the Code, discussed in Chapter 38 are made generally applicable to the GST tax by § 2661. Section 2032(c)(2), discussed at page 680, does not permit the use of the alternate valuation date unless its election would result in the reduction of the sum of the estate and GST taxes imposed on property included in the decedent's estate. Section 6166(i), discussed at page 782, treats any generation-skipping tax paid on account of a direct skip occurring at the same time and as a result of D's death as additional estate tax for purposes of electing to defer the estate tax attributable to certain closely held business interests.

Income Tax Basis. Section 2654(a) provides basis adjustments for property transferred in a GST that are intended to be analogous to those

provided by §§ 1014 and 1015 with respect to property received from a decedent and by inter vivos gift. The general rule is that the basis of property transferred in a GST is increased (not in excess of fair market value) by the portion of the GST tax attributable to the appreciation in value of the property immediately before the transfer.

If the GST is a taxable termination that occurs at the same time and as the result of the death of an individual, the assets receive a fair market value basis unless the inclusion ratio is less than one. § 2654(a)(2). In the latter case, the basis increase is limited to the product of the full basis increase and the inclusion ratio. Id.

Income Tax Deductions. Section 164(a)(4) provides an income tax deduction for the GST tax attributable to trust income distributions. For example, consider a trust for which the GST tax applicable rate is 35% and a beneficiary of the trust, GC, whose income is taxed at the marginal rate of 35%. If the trust distributes $1,000 of income to GC in 2011, GC pays a GST tax of $350. She also recognizes $1,000 of gross income. Section 164(a)(5) allows her to deduct the $350 GST tax liability, resulting in taxable income of $650 and an income tax liability of $227.50 (35% x $650). The result is a total tax liability of $577.50 ($350 GST tax plus $227.50 income tax). The trust itself pays no income tax on the $1,000 of income because it is allowed a deduction for distributable net income. See §§ 651(a) and 661(a). The rationale for the § 164(a)(5) deduction is to achieve the same result as would have occurred had the trust paid the income tax on the $1,000. Had the trust paid income tax of $350 on the $1,000 income, $650 would have been distributed to GC, resulting in $227.50 of GST tax liability and an aggregate tax liability of $577.50. For similar reasons, § 691(c)(3) permits an income tax deduction for the GST tax paid on account of a direct skip or taxable termination occurring as a result of the death of the transferor attributable to "items of gross income of the trust which were not properly includible in the gross income of the trust for periods before the date of such termination."

Redemption to Pay Estate Tax. Finally, § 303(d) makes the special redemption rules of § 303, discussed at, page 784 , applicable to the GST tax attributable to transfers occurring on and as a result of the death of an individual.

2. PLANNING CONSIDERATIONS

The structure of the GST tax and its interaction with the estate and gift tax create some important planning considerations. First, since the GST tax is tax exclusive for a direct skip while tax inclusive for taxable terminations or distributions, planners prefer to avoid taxable terminations and distributions where the $5 million GST exemption is not available. Second, since the gift tax is tax exclusive, planners prefer to structure GSTs, or the creation of trusts that will result in GSTs in the future, as inter vivos gifts, instead of as bequests. Third, maximum benefit is derived from the GST exemption by allocating it to property transferred into trust which is most likely to appreciate in value.

Estate planners will usually allocate an amount of the GST exemption to a transfer in trust such that the inclusion ratio is zero. This insures that all future appreciation of trust corpus will escape the GST tax. Moreover, planners prefer that the trust to which the exemption is allocated have only skip persons as beneficiaries to obtain the maximum benefit from the exemption. This preference will often result in transferors creating separate trusts for skip and non-skip persons or attempting to divide an existing trust into separate trusts. For further discussion, see Suter and Repetti, Trustee Authority To Divide Trusts, 6 ABA Probate & Property 54 (1992).

SECTION G. EFFECTIVE DATE RULES

In general, the GST tax applies to generation-skipping transfers made after October 22, 1986. However, inter vivos transfers made after September 25, 1985 are subject to the tax and are treated as if made on October 23, 1986. A number of exceptions to this rule are set forth in Reg. § 26.2601-1 and §§ 1433(a)-(d) of the Tax Reform Act of 1986, Pub. L. No. 99-514, 99th Cong. 2d Sess. (1986), as amended by § 1014(h) of the Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, 100th Cong. 2d Sess. (1988).

SECTION H. POLICY ISSUES

1. EVALUATION OF THE GENERATION-SKIPPING TAX

The current GST tax represents a significant congressional commitment to achieve greater equity in the transfer tax system. Moreover, when the tax applies, its coverage is more comprehensive and rational than the structure it replaced. However, it is important to note the policy decisions reflected in the legislation and alternatives which, if adopted, could improve the statute.

In deciding the role and scope of a tax on GST, Congress must address four basic issues: the level of transfers at which the tax will begin to apply, the event or events that will trigger the tax, the tax base and the tax rate. The following discussion focuses on these issues.

a. The Level Of Transfers At Which The Tax Should Apply

Under Chapter 13, the generation skipping tax will generally apply to transfers in excess of the GST exemption. It is necessary to analyze the objectives underlying the exemption to determine whether its size and structure are appropriate.

Structure of the Exemption. One of the purposes of the revised GST tax was to eliminate for a significant body of taxpayers and their advisors the need to consider and plan for the imposition of the GST tax. The decision to use an exemption rather than some other mechanism to avoid imposing an undue burden on taxpayers and their advisors was apparently prompted by several other considerations. First, a trust containing only exempt property would never have to keep any records relating to the tax. Second, due to the limited application of the tax, its most vociferous opponents could no longer argue for its repeal on the ground that most practitioners are unable to cope with the law. Finally, the Treasury would be relieved of the burden of monitoring, and providing the information necessary for the administration of the tax in the vast majority of trusts.

While the use of an exemption reduces the administrative burden of record keeping and monitoring, the structure of the exemption removes from the reach of the tax, subject only to the limitations imposed by the applicable rule against perpetuities, not only the GST exemption amount but also any appreciation that occurs after the exemption is claimed with respect to the transferred property. Thus, to achieve simplicity, Chapter 13 abandons the notion of periodic imposition of tax with respect not only to the exempt amount, but also its growth. The latter result is not compelled by the use of an exemption. An exemption could be structured to include appreciation in the tax base once the trust reaches a size that exceeds the exemption amount. Moreover the simplification theoretically made possible by the exemption has been significantly reduced by the decision to reflect the exemption in the tax rate rather than associating it with particular assets. Significant complexity arises in calculating the applicable fraction for initial transfers to a trust, subsequent transfers to a trust, and after a multiple skip has occurred.

Finally, the simplification potential of the exemption carries a significant price tag. First, many lawyers will not be knowledgeable about the GST tax so the exemption's applicability and intricacies may not be recognized in many cases. Second, there will be a psychological push to use trusts to take advantage of any available exemption. The frequency of "grandchild exclusion" trusts in post–1976 wills indicates that individuals will create trusts to take advantage of "benefits," even though in pre-GST tax days, those same individuals did not take advantage of unlimited generation-skipping opportunities.

b. Generation-Skipping Taxable Events

Chapter 13 represents a significant improvement over prior law in that direct skips are subject to the tax. However, there is a lack of symmetry in the treatment of multiple skips as compared to transfers that skip more than one generation.

The lack of symmetry is illustrated by the following examples. A trust for C for life, then for GC for life, remainder to GGC is subject to two GST taxes. Similarly, a trust for GC for life, then outright to GGC is subject to two GST taxes. Contrast the foregoing with transfers that skip over intervening

generations. For example, a trust for C for life, then outright to GGC is subject to only one GST tax. Similarly, an outright transfer directly to GGC is likewise subject to just one GST tax. In all these examples, GGC is the ultimate recipient of the property, but the tax burden differs depending upon the form of the transfer. If multiple GST taxes are imposed on transfers in which each generation holds a beneficial interest, multiple taxes should also be imposed on an equivalent basis for dispositions that skip over generations.

Both a 1969 Treasury study[18] and 1984 ALI Draft[19] proposed a single tax no matter how many generations were skipped by a transfer. This suggestion is inconsistent with the theoretical norm that a tax should be imposed in a manner that approximates the result that would have occurred had the property actually passed through the transfer tax base of each intervening generation. Moreover, the failure to impose an additional tax on multiple generation skips provides a tax preference for those with wealth sufficient to make such transfers. Several reasons, however, led the Treasury and the ALI Reporters to conclude that the structure necessary to impose symmetrical multiple taxation did not result in benefits sufficient to outweigh its complexity. First, multiple taxation results in additional statutory complexity. Second, as has been noted in the planning literature, careful drafters can blunt the effect of multiple taxation. For example, a sophisticated drafter could provide a savings clause to ensure that the property of any generation- skipping trust is passed through the estate of any grandchild who dies prematurely, thus avoiding a second generation-skipping tax while making available the deductions and credits that apply only to the estate tax. Third, it is the first generation skip that causes the greatest equity and

[18]U.S. Treasury Dept., Tax Reform Studies and Proposals, House Ways and Means Committee and Senate Finance Committee, 91st Cong., 1st Sess. 389-92, 397 (Comm. Print 1969).

[19]American Law Institute, Federal Estate and Gift Tax Project: Study On Generation-Skipping Transfers Under the Federal Estate Tax Discussion Draft No. 1, pp. 1-8, 11-20 (March 28, 1984).

neutrality problem.[20] Finally, existing empirical evidence indicates that very little property is transferred in a way that skips more than one generation.

The Chapter 13 solution, treating some generation-skipping transfers as subject to multiple taxation and others as subject to a single tax, is an unwarranted compromise. Because of the tax difference, transferors will be induced to utilize tax minimizing forms of disposition.

c. Tax Base and Tax Rates

The purpose of the GST tax is to approximate the tax result that would have occurred had the property passed through the tax base of an individual in the intervening generation. Thus, one must decide whether a GST should be treated as a taxable gift or bequest by the intervening generation. One must also decide the tax rate to be applied to the transfer.

The pre-1986 version of Chapter 13 attempted to replicate the tax burden of a GST precisely by identifying a "deemed transferor" and calculating the tax due by reference to the transfer tax profile of that individual. This attempt to achieve precision caused significant administrative problems. The current Chapter 13 abandons the attempt at precision and instead imposes a flat-rate tax at the maximum marginal

[20]The proposition is demonstrated by the following excerpt from Professor Shoup's classic study, Federal Estate and Gift Taxes, in which it is assumed "that the estate tax base is a circulating fund of constant size and that generations skipped are of constant duration. Then, if all decedents leave all their property in trusts that skip only one generation, 50 percent of the estate tax base is lost *** If all decedents leave all their property in trusts that skip two generations instead of one generation, the estate tax base is one-third what it would be under no skipping, instead of one-half. The reduction in base, from what it would be under one-generation skipping, is from 50 to 33 1/3 (with 100 as the base under no skipping). This is a decrease of one-sixth (16 2/3 percent) of the base under no skipping. Three-generation skipping reduces the base from 33 1/3 to 25, or by one-twelfth of the base under no skipping. Thus, the big erosion occurs with one-generation skipping. Further skipping is proportionately much less serious." C. Shoup, Federal Estate and Gift Taxes 33 (1967).

transfer tax rate. The use of a flat-rate tax at the maximum tax rate greatly simplifies the administration of the GST tax. However, the tax base for GSTs, in trust is calculated on a tax inclusive basis while the tax base for direct skips is calculated on a tax exclusive basis. This disparity imposes heavier tax burdens on taxable terminations or taxable distributions than direct skips. The lower rate on direct skips violates the neutrality principle.

Study Problems p. 33.1-33.4: Replace Questions 1 through 11 with the following:

I. The Need for the GST Tax (Supplement pp. 7.1 – 7.8)

Question 1

If Professor Casner's suggestions (Supplement pp. 7.2 – 7.8) were adopted today, would S's gross estate include any of the trust corpus or accumulated income?

II. Basic Concepts (Supplement pp. 7.9 – 7.20)

Question 2

Determine whether the following transfers are GSTs:

(a) D gives $100,000 to Grandchild.

(b) D irrevocably transfers $100,000 in trust, income to Child for life, remainder to Grandchild.

(c) D irrevocably transfers $100,000 in trust, income to Grandchild for ten years, remainder to Grandchild or Grandchild's estate.

(d) D, age 60, gives $100,000 to Friend, age 20, who is not related to D.

Question 3

D irrevocably transfers $100,000 in trust, income to Child for life, remainder to Grandchild. D gives the trustee, her lawyer, discretion to distribute income to Grandchild during Child's life.

(a) Is D's transfer in trust a GST?

(b) If the trustee makes income distributions to Grandchild, will the distributions be GSTs?

(c) Upon Child's death, will the distribution of the remainder interest to Grandchild be a GST?

Question 4

Suppose that A followed Professor Casner's advice and established a trust, income to S for life, income to S's child for life, remainder to S's grandchild or grandchild's estate. If Professor Casner's suggestion were adopted today, would distributions from the trust created by A to S's child (A's grandchild) be subject to GST tax? Would the distribution to S's grandchild (A's great-grandchild) upon dissolution of the trust be subject to GST tax?

Question 5

D makes an irrevocable inter vivos gift of $10,000 in trust. Under the trust indenture, the trustee has discretion to distribute as much income and principal to Grandchild as the trustee deems appropriate. On Grandchild's death, corpus and accumulated income are to pass to Grandchild's probate estate. D gives Grandchild a *Crummey* power that allows him to withdraw $10,000 within 30 days of D's transfer in trust. Has a GST occurred? Will it be subject to the GST tax?

III. Calculating the GST Tax (Supplement pp. 7.20 – 7.33)

Question 6

D is considering two alternative forms of transfers to Grandchild such that Grandchild will have $100,000 after the payment of all transfer taxes. Assume in each case that D is in the maximum estate, gift and GST tax rate bracket for the year 2011 (35%), and that D has already used her unified credit, annual exclusion and $5,000,000 GST exemption.

Under Plan 1, D will irrevocably transfer $100,000 in trust to Grandchild. Pursuant to the terms of the trust, income will be payable to Grandchild for 30 years, with remainder to Grandchild or Grandchild's estate.

Under Plan 2, D will bequeath an amount to Grandchild such that Grandchild will have $100,000.

(a) How much will D have to start with in Plan 1 in order to make the transfer in trust and pay all transfer taxes? What transfer taxes will be payable in Plan 1 and who will be liable to pay those taxes?

(b) Why will D have to initially possess $207,692.31 in her taxable estate at death in Plan 2 in order to be able to transfer $100,000 to Grandchild after the payment of all taxes?

Question 7

Refer back to Plan 1 in Question 6.

(a) Assume that the trust distributes $5,000 of income to Grandchild at the end of the first year the trust is formed. How much GST tax will be due?

(b) Assume that the trust's corpus at the end of 30 years is $100,000. How much GST tax will be due when the $100,000 corpus is distributed to Grandchild?

Question 8

D makes an irrevocable inter vivos transfer in trust of $100,000. Under the terms of the trust, the trustee, who is not D, has sole discretion to distribute or not distribute income to Child and Grandchild. Upon child's death, the trust corpus and any accumulated income are to be paid to Grandchild. D elects to allocate none of his GST exemption to the transfer. Assume that the maximum rate for the estate and gift tax is 35% and that D has already used her annual exclusion and unified credit.

(a) What is the transfer tax effect upon creation of the trust?

(b) What is the transfer tax effect if trustee distributes $20,000 of income to Grandchild?

(c) What is the transfer tax effect of the transfer of the trust corpus and accumulated income to Grandchild upon Child's death? Assume that the amount distributed to Grandchild is $100,000.

Question 9

D irrevocably transfers $100,000 to Grandchild as an inter vivos gift. D elects to have only $50,000 of her GST exemption apply to the gift. Assume that D has already used her annual exclusion and unified credit and that the maximum estate and gift tax rate is 35%. How much GST tax is due?

Question 10

D irrevocably transfer $1 million in trust, income to Child for life remainder to Grandchild. How much GST tax will be due if D's allocates $1

million of her GST exemption to the transfer in trust and the trust corpus has a value of $50 million at the date of Child's death? Assume that the maximum estate and gift tax rate is 35%.

Question 11

D irrevocably transfers $1 million in trust, income to D for life, remainder to Grandchild. How much GST tax will be due if D allocates $1 million of his GST exemption to the transfer in trust and the trust corpus has a value of $10 million at D's death? Assume that the maximum estate and gift tax rate is 35%.

PART VIII

VALUATION

CHAPTER 35 – VALUATION METHODS

***Casebook* p. 723-725**: Delete the material that begins with the carryover paragraph at the bottom of p. 723 through the last full paragraph at the bottom of p. 725 and replace it with:

SECTION C. THE USE OF MORTALITY AND INTEREST TABLES IN VALUATION

Special problems arise in connection with the valuation of life, remainder, and reversionary interests, as well as the valuation of annuities. The value of these interests depends upon the longevity of a person who is used as a measuring life and the selection of an appropriate rate of return or interest rate for such property. Section 7520(a) requires that the values be determined using tables prescribed by the IRS. The IRS publishes the tables on the web at http://www.irs.gov/retirement/article/0,,id=206601,00.html. In addition, IRS Publication 1457 Version 3A (2009) contains some examples for determining the values of annuities, life estates, terms of years, remainders and reversions. IRS Publication 1458 Version 3B (2009) includes tables for calculating the values of remainder interests in charitable remainder unitrusts, as defined in Reg. §1.642(c)-5.[1]

The tables determine value for property interests measured by a life by making gender neutral actuarial assumptions about the longevity of the measuring life. These values are presented for various interest rates. The actual interest rate selected by a taxpayer to calculate a value must equal 120% of the Federal midterm rate in effect under § 1274(d)(1) for the month in which the valuation date falls. Congress opted for a "bright-line" determination of appropriate rates of return instead of trying to determine suitable rates based on the nature of the specific property.

[1] See p. 545 of the Casebook for a discussion of charitable remainder unitrusts.

Annuities—The IRS has issued tables to value annuities that pay a fixed amount at the end of each year for a fixed period of time or for a measuring life. Regs. §§ 20.7520-3(b)(1)(i); 20.7520-3(b)(1)(i); 20.2031-7T(d)(2)(iv) and 25.2512-5T(d)(2)(iv).[2] If the annuity will pay a fixed sum for a period of years, Table B is used. For example, assume that an annuity will pay $1,000 each year for 10 years and that 120% of the Federal midterm rate is 10%. Table B requires a factor of 6.1446 to be used. (Table B may be accessesd at http://www.irs.gov/retirement/article/0,,id=206601,00.html.) This factor, multiplied by the yearly $1,000 annuity payment, yields a value for the annuity of $6,144.60.

If the annuity will pay a sum at the end of each year for a measuring life, than Table S is used. Suppose that A, age 40, will receive $1,000 per year for her life and that 120% of the federal midterm rate equals 10%. (The relevant portion of Table S may be accessed on the web at http://www.irs.gov/retirement/article/0,,id=206601,00.html.) Table S provides a factor of 9.4087, which yields a value of $9408.70 for the annuity (9.4087 x $1,000).

Terms of Years and Life Interests—If the interest is the right of a person to receive income from productive property or the right to use property for a term of years or for a measuring life, then Tables B and S are again used. Regs. §§ 20.7502-3(b)(1)(i); 25.7502-3(b)(1)(i); 20.2031-7T(d)(2)(iii) and 25.2512-5T(d)(2)(iii). For example, assume that A has the right to receive all the income for 10 years from productive property which has a fair market value of $100,000. Table B[3] would require a factor of .614457 to be used, assuming that 120% of the Federal midterm rate is 10%. This would result in a value of A's term interest equal to $61,445.70 (.614457 x $100,000).

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[2] Annuities that will make payments other than at the end of each year are valued by modifying the factors contained in the tables. §§ 20.2031-7T(d)(2)(iv) and 25.2512-5T(d)(2)(iv).

[3] http://www.irs.gov/retirement/article/0,,id=206601,00.html.

Suppose instead that A, age 40, has the right to receive all the income from the same property for the rest of his life. Table S[4] would require a factor of .94087 to be used, again assuming that 120% of the Federal midterm rate is 10%. Thus A's life interest would be valued at $94,087 (.94087 x $100,000).

Remainder or Reversionary Interest—If the interest is the right to receive property at the end of one or more measuring lives or defined period, Tables B and S again apply. Regs. §§ 20.7520-3(b)(1)(i); 25.7520-3(b)(1)(i); 20.2031-7T(d)(2)(ii) and 25.2512-5T(d)(2)(ii). For example, assume that A is given the right to receive a fee simple interest in property in 10 years and that the property has a current fair market value of $10,000. Table B[5] would require a factor of .385543 (assuming that 120% of the Federal midterm rate is 10%) with the result that the value of the remainder interest is $3,855.43 (.385543 x $10,000).

Alternatively, suppose that A is given the right to receive the property upon the death of B, who is currently 40. Table S[6] would require a factor of .05913 (again assuming that 120% of the Federal midterm rate is 10%). The value of the remainder interest would therefore be $591.30 (.05913 x $10,000).

Recall that § 2037 requires decedent's estate to determine whether her reversionary interest immediately before her death exceeds 5% of the property subject to the reversionary interest (see Chapter 16). For example, suppose D transferred property in trust, income payable to S for life and remainder payable to D, or if D is not living, remainder payable to C or C's estate. The value of D's reversionary interest equals the probability that she would survive S immediately before her death multiplied by the value of the remainder interest. The tables published by the IRS do not provide the

[4] http://www.irs.gov/retirement/article/0,,id=206601,00.html. The Table B factors for term remainder interests are also reproduced in Reg. § 20.2031-7(d)(6).
[5] http://www.irs.gov/retirement/article/0,,id=206601,00.html.
[6] http://www.irs.gov/retirement/article/0,,id=206601,00.html. The Table S factors for life remainder interests are reproduced in Reg. § 20.2031-7T(d)(7).

information necessary to make this determination, but the IRS will perform the calculations upon request.

Study Problems p. 35.4: Replace Questions 6 through 9 with the following:

III. THE USE OF MORTALITY AND INTEREST RATE TABLES

Question 6

D transfers Green Acre to Child in exchange for Child's promise to pay $10,000 per year at the end of each year for 10 years. Green Acre has a fair market value of $61,446 at the time of the transfer. Has D made a taxable gift? Assume for purposes of this question that 120% of the Federal midterm rate equals 10% and use the tables at http://www.irs.gov/retirement/article/0,,id=206601,00.html.

Question 7

D, age 50, transfers stock to Child in exchange for Child's promise to pay D $1,000 at the end of each year for the remainder of D's life. The stock has a value of $8,896.70. Has D made a taxable gift? Assume for purposes of this question that 120% of the Federal midterm rate equals 10% and use the tables at http://www.irs.gov/retirement/article/0,,id=206601,00.html.

Question 8

D gives Friend a life interest in Green Acre for which Friend's life is the measuring life. Green Acre has a fair market value of $100,000 at the time of the gift. If Friend is age 20, what is the value of D's gift of the life estate? Friend is not related to D. Assume for purposes of this question that 120% of the Federal midterm rate equals 10% and use the tables at http://www.irs.gov/retirement/article/0,,id=206601,00.html.

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Question 9

D transfers 100,000 in trust, income to Child for 15 years, remainder to a University that satisfies the requirements of § 2055(a)(2). Assume for purposes of this question that 120% of the Federal midterm rate equals 10% and use the tables at http://www.irs.gov/retirement/article/0,,id=206601,00.html.

(a) What is the value of Child's term interest?

(b) What is the value of the school's remainder interest?

PART IX
ADMINISTRATIVE ASPECTS OF WEALTH TRANSFER TAXES

CHAPTER 38 – TAX RESPONSIBILITIES OF THE EXECUTOR

***Casebook* p. 780**: Replace the first paragraph with the following:

As explained in Chapter 5, the executor of an estate that exceeds a threshold amount ($5 million in 2011) generally must file an estate tax return, and pay any estate tax due, within nine months of the decedent's death. §§ 6075, 6151(a).[1] The executor, however, may request extensions of time for both filing and payment. In 2010 and 2011, an executor of an estate that is less than the $5 million filing threshold nevertheless may file an estate tax return to enable the surviving spouse to assume the deceased spouse's unused exclusion amount.

***Casebook* p. 780**: Add the following to the end of the last paragraph:

In addition, the 2010 Act two new elections to be made on a decedent's estate tax return. For decedents dying in 2010, the executor may elect to have the pre-2010 Act law (no estate tax, § 1022 carryover basis) apply to estate. For decedents dying in 2011 and 2011, the executor may elect for the surviving spouse to assume the deceased spouse's unused exclusion amount.

[1] In FY 2010, 28,780 estate tax returns were filed. Internal Revenue Service 2010 Data Book, Table 3.

***Study Problems* p. 38.1**: Replace Questions 1 and 2 with the following:

Question 1

Decedent dies on January 1, 2011 with a gross estate of $4,500,000. Must Decedent's executor file an estate tax return?

Question 2

Decedent dies on January 1, 2011 with a gross estate of $5,100,000. Decedent's executor incurs $150,000 of administration expenses deductible under § 2053. Must Decedent's executor file an estate tax return?

***Study Problems* p. 38.1**: Replace Question 3 with the following:

Question 3

Decedent dies on January 1, 2011 with a gross estate of $5,100,000.

(a) What is the due date for payment of the estate tax?

(b) What is the due date for payment of the estate tax if the executor establishes a "reasonable cause" for an extension?

***Study Problems* p. 38.2**: Replace Question 4 with the following:

Question 4

Decedent dies on January 1, 2011 with a gross estate of $6,100,000. Decedent's executor incurs $100,000 of administration expenses deductible under § 2053. Included as part of Decedent's estate is 30% of the stock of Family Corp., valued at $2,400,000.

(a) What is the estate tax liability?

(b) Can the executor make a § 6166 election?

(c) How much of the estate tax liability can be deferred under § 6166?

(d) If the executor elects the maximum deferral period, when are payments of interest and principal due?

(e) What are the tax consequences under § 6166 if executor sells the stock to a third party on January 1, 2014?

***Study Problem* pp. 38.2 to 38.3**: Replace Question 5 with the following:

Question 5

Assume the same facts as in Question 4, except that the stock of Family Corp. owned by Decedent constitutes 10% (not 30%) of the outstanding stock, and that the stock had a basis of $1,000,000 in Decedent's hands. Assume also that in order to provide liquidity to pay the estate tax liability, Family Corp. on July 1, 2011 redeems the stock held by the executor for $2,600,000 (its then-fair market value). Assume further that the redemption would be taxable as a dividend under § 301 ($2,600,000 x 35% ordinary income rate = $910,000 tax).

(a) Is the redemption taxable at the preferential 15% capital gains rate under § 303?

(b) If so, what is the tax savings achieved through the application of § 303?

***Casebook* p. 787, n.19**: Replace the last sentence with the following:

In 2011, the inflation-adjusted ceiling is $1,020,000. Rev.Proc. 2010-40, § 3.20, 2010-46 I.R.B. 663 (Nov. 15, 2010)).

***Casebook* p. 820:** Add the following before ILLUSTRATIVE MATERIAL:

Treasury Department Circular No. 230
(Rev. 6-2011)

Par. 15. Section 10.34 is amended by:

1. Adding paragraph (a).
2. Redesignating paragraph (f) as paragraph (e).
3. Revising newly designated paragraph (e).

The revision and addition read as follows:

§ 10.34 Standards with respect to tax returns and documents, affidavits and other papers.

(a) *Tax returns*.

(1) A practitioner may not willfully, recklessly, or through gross incompetence-

(i) Sign a tax return or claim for refund that the practitioner knows or reasonably should know contains a position that-

(A) Lacks a reasonable basis;
(B) Is an unreasonable position as described in section 6694(a)(2) * * *; or
(C) Is a willful attempt by the practitioner to understate the liability for tax or a reckless or intentional disregard of rules or regulations by the practitioner as described in section 6694(b)(2) of the Code (including the related regulations and other published guidance).

(ii) Advise a client to take a position on a tax return or claim for refund, or prepare a portion of a tax return or claim for refund containing a position, that-

(A) Lacks a reasonable basis;
(B) Is an unreasonable position as described in section 6694(a)(2) * * * ; or
(C) Is a willful attempt by the practitioner to understate the liability for tax or a reckless or intentional disregard of rules or regulations by the practitioner as described in section 6694(b)(2) of the Code (including the related regulations and other published guidance).

(2) A pattern of conduct is a factor that will be taken into account in determining whether a practitioner acted willfully, recklessly, or through gross incompetence.

* * * * *

(e) *Effective/applicability date*. Paragraph (a) of this section is applicable for returns or claims for refund filed, or advice provided, beginning August 2, 2011. Paragraphs (b) through (d) of this section are applicable to tax returns, documents, affidavits, and other papers filed on or after September 26, 2007.

***Casebook* pp. 820-21, n.48:** Add the following at the end:

Todres, New York's Law of Tax Malpractice Damages: Balanced or Biased?, 86 St. John's L. Rev. ___ (2012); Note, The Tax Lawyer's Dilemma: Recent Developments Heighten Tax Lawyer Responsibilities and Liabilities, 2011 Colum. Bus. L. Rev. 258.

***Casebook* pp. 821, n.49:** Add the following at the end:

Beyer, Avoid Being a Defendant: Estate Planning Malpractice and Ethical Concerns (2011).