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Robert P. Achenbach, Jr.

Contributing Editor

Dr. Neil E. Harl, Esq.

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Tempted to Make Big Gifts in 2010?

-by Neil E. Harl*

As the year 2010 enters its final month, with no federal estate tax in effect,¹ no generation skipping transfer tax in effect² and a federal gift tax at a rate of 35 percent,³ the temptation is to make major gifts late in 2010 *if that is a step the donor would like to take*. Such a move is particularly attractive under the assumption that the Congress will not enact legislation that will be retroactive to January 1, 2010 and impose a federal estate tax and a generation-skipping transfer tax for 2010 and that would also modify the federal gift tax rate for 2010, up from the 35 percent level. Although there are opinions to the contrary, there is substantial authority that enactments on a retroactive basis are constitutional. However, the agreement announced on December 6, 2010, between The President and negotiators from Congress, referred to a two-year extension of the federal estate tax (apparently for 2011 and 2012). Until legislation is actually enacted into law, it is hazardous to opine about the effective date and the term of the extension as well as the provisions included therein.

Constitutionality of retroactive enactment of legislation

There is, of course, no assurance of how the U.S. Supreme Court would rule but the court has upheld on several occasions retroactive tax legislation against a due process challenge.⁴ Lower courts have also, on occasion, rendered opinions on the constitutionality of retroactive tax legislation.⁵ Some opinions have stated that the validity of a retroactive tax provision under the due process clause depends upon whether "retroactive application is so harsh and oppressive as to transgress the constitutional limitation."⁶ The court has also asked, "is it justified by a rational legislative purpose?"⁷

The relatively recent case of *Carlton v. United States*⁸ is instructive as to the court's attitude toward retroactive tax enactments. In that case, the taxpayer had died on September 29, 1985. His estate, on December 10, 1986, purchased shares of a corporation which the estate sold at a slight loss two days later to an employee stock ownership plan (ESOP). The estate claimed a deduction on the federal estate tax return, Form 706, for one-half of the proceeds of the sale as provided by statute.⁹ Section 2057 of the Internal Revenue Code then allowed a 50 percent deduction from the value of the gross estate for the proceeds of any sale of "qualified employer securities" to an employee stock ownership plan or an eligible worker-owned cooperative.¹⁰ On January 5, 1987, the Internal Revenue Service

* Charles F. Curtiss Distinguished Professor in Agriculture and Emeritus Professor of Economics, Iowa State University; member of the Iowa Bar.

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announced that it would grant such a deduction only when the securities were owned before the person's death.¹¹ On December 22, 1987, an amendment to that effect was enacted and made effective as though it were part of the statute enacted on October 22, 1986.¹² The United States Supreme Court concluded that the retroactive amendment met the due process requirements and was constitutional.¹³

The present court has not accepted review on a case involving enactment retroactive to an earlier date but the history of cases before the court would suggest that it is fairly likely that a retroactive enactment would be upheld.

The advantage of a gift in 2010

Part of the advantage of a gift, even a taxable gift, in 2010 has been that the federal gift tax rate of 35 percent for 2010 gifts was well below the likely federal estate tax rate at death, assuming that the Congress either acts to pass legislation covering future years or allows the provisions effective in 2011 to continue. The latter would involve a 55 percent top rate. A new enactment would likely impose a 45 percent rate although rates ranging up to 65 percent¹⁴ and as low as 35 percent (after 10-years)¹⁵ have been introduced in Congress. The agreement announced on December 6 appears to parallel the latter.

A gift in 2010, which would normally be subject to generation-skipping transfer tax, would not encounter that tax if made in 2010 unless retroactive legislation is passed and is held constitutional.

Gross-up rules

It is important to take into consideration the two "gross-up" rules that could come into play. If a generation-skipping tax were enacted on a retroactive basis, and a taxable gift were to have been made involving a direct skip, the amount of any gift is increased by the amount of any generation-skipping tax imposed on the transferor.¹⁶ Also, if a gift is made within three years of death, the amount of the gross estate is increased by the amount of any tax paid by the decedent or the decedent's estate on any gift made by the decedent or spouse during the three year period ending on the date of the decedent's death.¹⁷

Effect on the applicable exclusion amount

It is not known, of course, whether legislation to reinstate the federal estate tax will include a recoupling of the federal estate tax and federal gift tax as was the case before 2002. However, it is important to note that any use of the federal gift tax unified credit amount of \$1,000,000 is an "advance" of that amount against the federal estate tax applicable exclusion amount at death.¹⁸

In conclusion

The uncertainty over (1) whether the Congress will act yet this year to adopt a federal estate tax system and generation-skipping tax system (or continue the systems in place in 2009); (2) wait until 2011 to act (with or without retroactivity; or (3) finish the repeal commenced in the 2001 Act, makes planning extremely difficult. It all depends upon how one views the probabilities of those possible outcomes actually occurring and how the client's objectives can best be met.

ENDNOTES

¹ See EGTRRA of 2001, Pub. L. No. 107-16, 115 Stat. 38 (2001).

² *Id.*

³ I.R.C. § 2502(a)(2).

⁴ See, e.g., *United States v. Carlton*, 512 U.S. 26 (1994); *United States v. Hemme*, 476 U.S. 558 (1986); *United States v. Darusmont*, 449 U.S. 292 (1981); *Welch v. Henry*, 305 U.S. 134 (1938); *United States v. Hudson*, 299 U.S. 498 (1937); *Milliken v. United States*, 283 U.S. 15 (1931); *Cooper v. United States*, 280 U.S. 409 (1930).

⁵ E.g., *Nationsbank of Texas, N.A. v. United States*, 269 F.3d 1332 (Fed. Cir. 2001) (top federal estate tax rate dropped from 55 percent to 50 percent in 1993; the decedent died in March of 1993 but on August 10, 1993, OBRA was enacted a part of which increased the top rate to 55 percent and made it effective for persons dying on or after January 1, 1993; the Ninth Circuit Court of Appeals held the move to be constitutional).

⁶ See *Welch v. Henry*, 305 U.S. 134, 147 (1938).]

⁷ See *United States v. Carlton*, 512 U.S. 26 (1994).

⁸ 512 U.S. 26 (1994), *rev'g*, 993 F.2d 1051 (9th Cir. 1992).

⁹ I.R.C. § 2057 (before repeal by the Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239).

¹⁰ I.R.C. § 2057(a).

¹¹ Notice 87-13, 1987-1 C.B. 432, 442.

¹² Tax Reform Act of 1986, Pub. L. No. 99-514, § 10411(b), 100 Stat. 2085 (1986).

¹³ *United States v. Carlton*, 512 U.S. 26 (1994).

¹⁴ S. 3533 and H.R. 5764, The Responsible Estate Tax Act.

¹⁵ H.R. 3905, The Estate Tax Relief Bill of 2009, sponsored by four House of Representatives members on a bi-partisan basis.

¹⁶ I.R.C. § 2515.

¹⁷ I.R.C. § 2035(b).

¹⁸ See I.R.C. § 2503(a) (definition of "taxable gifts"); I.R.C. § 2001(b) (definition of "adjusted taxable gifts"). There is no mention of the gift tax unified credit amount under I.R.C. § 2505(a).

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More information will be posted in early 2011.