

Some Types of Taxes

Income (state and federal):

- Applicable to almost all income except gifts.
- Graduated Scale, based on income level.

Capital Gains (federal)

- Figured out by taking the sale price and subtracting the “basis” (the basis is the price paid originally for the object that is being sold).

Sales (state)

- Taxed as a percentage of the sale price for goods and/or services.

Property (county) [sometimes known as school tax].

- Each year, property owners pay a percentage of the property’s value.

Types of Taxes Most Relevant to our Course (the “transfer” taxes)

Gift Tax (federal)

→ A percentage of the gift must be paid by the donor.

Estate Tax (federal and some states)

→ A percentage of a decedent’s estate over a certain threshold must be paid by the estate.

Inheritance Tax (some states) [alternative to estate tax].

→ A percentage of what is inherited by a person paid by that person.

Generation Skipping Transfer Tax

→ Extra tax on gifts that “skip” a generation (e.g. grandfather to granddaughter) to prevent people from avoiding transfer taxes by “skipping” a generation.

Gift Tax

- ✚ Taxed only on *gratuitous* transfers

If there is a sale for less than the market value, it's a part gift- part sale; so gift tax is only on the gift part.

- ✚ *-Graduated* scale based on amount of the gift.

- ✚ Tax is measured exclusively of the gift
[The percentage is based on the gift without the tax component.]

Example: Transfer tax rate of 20%: Donor wants to give \$100,000 to a donee.

	Exclusive	Inclusive
Amount looked At when Determining tax	\$100,000 (the gift without the necessary tax)	\$125,000 (the gift with the necessary 20% tax included)
Amount necessary to allow the receiver to keep \$100,000	\$120,000 (\$20,000 paid on the \$100,000 transfer)	\$125,000 (20%, or \$25,000) given on the \$125,000; so the receiver keeps \$100,000
Effective tax rate on the gift	20%	25%

Cost Basis

(Important for measuring the gain realized or loss sustained when a person sells an item.)

- ✚ **For items and are bought for fair market value, the buyer's purchase price becomes the buyer's basis.**

- ✚ **For items received as a gift, the basis or the donor carries over to the donee ("carryover" basis).**

- ✚ **For part gift, part sale transactions, the basis is a combination:**
 - For the gift part, the basis carries over.
 - For the sale part, the basis becomes the sale price.

- ✚ **For items received from a decedent via inheritance or Will, the basis becomes the fair market value as of the date of death ("step up" in basis).**

Example for Basis in a Part Gift Part Sale Transaction

Mary buys a house for \$100,000 in 1980. In 2003, the house is worth \$500,00. She “sells” the house to her son, Robert, for \$200,000.

- This is a part gift part sale transaction; the sale is for \$200,000 of the house. The gift is of \$300,000 worth of the house.

Basis:

- **The sale price becomes part of the basis (\$200,000).**
- **The remaining \$300,000 corresponds to 60% of the gift; so 60% of Mary’s basis transfers to Robert. Since Mary’s basis was \$100,000, \$60,000 gets added to Robert’s basis.**
- *So, Robert’s new basis is \$260,000.*

(If Robert sells the house for \$500,000, he will have to pay capital gains tax on \$240,000.)

Exemptions for the Gift Tax

Annual Exclusion

- Currently \$13,000 per year per beneficiary (indexed for inflation).

Gift Tax Unified credit

- Each person gets \$1,000,000 (currently) of tax-free gifts (not including the other exemptions) over the course of a lifetime.

Marital deduction

- Gifts between spouses who are U.S. Citizens are completely tax free.
- If one spouse is not a U.S. Citizen, the deduction is (currently) \$134,000 as of 2010 (indexed for inflation).

(Reason: The government is afraid that wealthy people will give all their appreciated property to a foreign spouse and thus avoid ever having to pay capital gains tax on that property.)

Charitable deduction

- **No limit**

Estate Tax

- **Measured Inclusively**
- **For 2011 and 2012: exemption of \$5,000,000; maximum rate of 35%**
- **As of Jan. 1, 2013: \$1,000,000 exemption; maximum rate of 55% (unless the law is changed... again!)**
- Estate tax repeal and other legislation currently in Congress.
- Estate expenses (debts, executor's fees, attorney fees etc.) are exempt.
- Marital and Charitable deductions apply as well.
- State Death tax deduction.