CHAPTER 1

Federal Taxes: An Overview

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I. FUNDAMENTAL PRINCIPLES OF FEDERAL TRANSFER TAXATION

This overview deals exclusively with federal law and primarily with U.S. citizens and residents.[1] Some states have enacted separate death tax systems. For further explanation of state systems, please see Chapter 2.

A. Introduction

The Internal Revenue Code[2] (hereinafter Code or IRC) currently taxes transfers of property during lifetime or at death through two interrelated tax systems, the federal gift tax and the federal estate tax, and also via federal generation-skipping transfer (GST) taxation. These transfer taxes have been and continue to be in flux. For example, the Economic Growth and Tax Reconciliation Relief Act of 2001[3] (EGTRRA) initially provided for a gradual phaseout of the estate tax and GST tax (but not the gift tax) between 2002 and 2010.[4] During the 2002 to 2010 period, the federal estate tax exemption increased and the maximum federal estate and gift tax rates decreased.[5] The federal gift tax exemption remained at $1 million.[6] After the phaseout period, the estate tax and the GST tax (but not the gift tax) were scheduled to be abolished for only one year, namely, calendar year 2010. For gifts made and estates of decedents dying after December 31, 2010, EGTRRA provisions would no longer be in effect, and the pre-2002 tax rates and exemption amounts (i.e., a maximum tax rate of 55 percent and exemption amounts of $1 million) would be reinstated.[7]

In 2010, however, Congress, due to economic and political pressures, passed the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 (2010 Act).[8] Instead of repeal in 2010 under EGTRRA, the 2010 Act allowed the estates of those individuals dying in 2010 the option of electing to be subject to the estate tax regime with a $5 million exemption or be subject to a carryover basis regime.[9] The 2010 Act also introduced the concept of portability, as discussed in subsection I.B.3. of this chapter.[10] The American Taxpayer Relief Act of 2012[11] made permanent the exemption provisions of the 2010 Act.[12] These exemption provisions allowed for a reunified exemption of $5 million for years 2010 and 2011 and an inflation adjustment of the $5 million exemption amount thereafter. Set forth in this chapter is an introduction to the federal gift tax, the federal estate tax, and the federal GST tax as affected by the Tax Cuts and Jobs Act[13] as well as some related federal income tax provisions.

B. Unified Credit System

1. *Applicable Exclusion Amount*

To date, the federal estate and gift tax exemptions are unified. The unified exemption, that is, "applicable exclusion amount," is the fair market value of property a taxpayer may transfer during lifetime or at death without being subject to any federal gift or estate tax. In the case of a surviving spouse,[14] the applicable exclusion amount is the sum of the basic exclusion amount and the deceased spousal unused exclusion amount (DSUE) to be discussed later in subsection I.B.3.[15] Under current law, each taxpayer has a basic exclusion amount of $10 million, indexed for inflation.[16] In 2018, this inflation adjustment results in a basic amount of $11,180,000.[17]

EXAMPLE

In 2018, a single (never married) individual dies without making lifetime taxable gifts (as described in subsection I.C.). At his death, the fair market value of his gross estate is $11,180,000. No federal estate tax is due. In addition, because the individual's gross estate (including any and all of the individual's lifetime taxable gifts) does not exceed the basic exclusion amount in effect for the year of the individual's death, no federal estate tax return (Form 706[18]) is required to be filed.[19]

2. *Applicable Credit Amount*

The applicable credit amount is the tentative tax calculated per the rate schedule under Code section 2001(c) on the applicable exclusion amount. Assuming no DSUE, the applicable credit amount is $4,417,800, the tentative tax on $11,180,000 for 2018.[20] Generally, this credit is applied against the federal gift tax due on any taxable gifts a taxpayer makes during his or her lifetime with any remaining credit amount available to reduce the federal estate tax otherwise due upon the taxpayer's death. Since 2013, the unified gift and estate tax rate has remained constant at 40 percent, while the applicable exclusion amount and corresponding basic credit amount have increased as follows:

Calendar Year	Credit Amount	Exclusion Amount	Highest Rate
2013	$2,045,800	$5.25 million	40%
2014	$2,081,800	$5.34 million	40%
2015	$2,117,800	$5.43 million	40%
2016	$2,125,800	$5.45 million	40%
2017	$2,141,800	$5.49 million	40%
2018	$4,417,800	$11.18 million	40%

To reiterate, any use of the taxpayer's applicable exclusion amount and corresponding credit during his or her lifetime reduces the applicable exclusion amount and corresponding credit available at death on a dollar-for-dollar basis.

Example

In 2017, a single (never married) individual uses up his entire $5.49 million basic exclusion amount on taxable gifts, and then passes away in 2018 when the basic exclusion amount is $11.18 million. Assuming no statutory increase in the exclusion amount in year of death, the decedent's estate will have an exclusion amount of $5.69 million available at death.

In 2026, the basic exclusion amount is scheduled to revert to $5 million, adjusted for inflation based upon the chained consumer price index,[21] with a corresponding decrease in the applicable credit amount.[22]

Practice Note

Given the basic exclusion amount is scheduled to revert to $5 million from $10 million (before inflation adjustments), some practitioners are concerned whether transfers during the interim period (i.e., between December 31, 2017, and January 1, 2026) will be "clawed back." That is, whether an individual or an estate will be subject to federal gift or estate taxation because the increased exclusion amount no longer exists. New Code section 2001(g)(2), added by the Tax Act and Jobs Act, gives the U.S. Treasury the authority to issue regulations. Guidance, as part of the Treasury Department's 2017–2018 Priority Guidance Plan, is expected.[23]

Update to Practice Note

On November 23, 2018, the Internal Revenue Service published proposed regulations (REG-106706-18; 83 F.R. 59343-59348) addressing the impact of the Tax Cuts and Jobs Act's temporary changes to the basic exclusion amount. In attempting to resolve the "clawback" issue, the proposed regulations would amend Regulation section 20.2010-1 by generally allowing a decedent's estate to compute the applicable credit amount using the higher of the basic exclusion amount applicable at date of gift or at date of death. *See* Prop. Reg. § 20.2010-1(c)(2) (Example). This special rule effectively would prevent inappropriate taxation of gifts made during the period of the increased basic exclusion amount.

3. Portability

If a decedent's estate did not utilize the entire exemption amount and corresponding credit in determining federal estate tax liability, it was lost. This most often occurred in the event the decedent left his entire estate to his surviving spouse and, thus, solely applied the marital deduction in the estate tax calculation.[24] To ensure full use of the exemption amount, practitioners recommended credit shelter trusts, as discussed in subsection I.D.3. Effective for estates of decedents dying and gifts made after December 31, 2010, portability of the decedent's unused exclusion amount between spouses[25] is allowed.[26] To take advantage of this change, the estate of a married individual must timely file a federal estate tax return to *elect* to allow the decedent's surviving spouse to utilize the DSUE amount.[27] An extension of time, under Regulation section 301.9100-3, solely to elect portability is not available for those estates above the threshold basic exclusion (i.e., already required to timely file a federal estate tax return).[28] Once the due date of the filing of the federal estate tax return, including extensions[29] actually granted, has passed, the election is irrevocable.[30] Generally, the surviving spouse may use the DSUE amount during lifetime for taxable gifts and/or at death for determination of federal estate tax due.[31] Unlike the basic exclusion amount, the DSUE is *not* indexed for inflation.[32] In addition, portability of the GST tax exemption, as discussed in subsection E.3., is *not* available.[33]

Example

Mike and Sarah are married.[34] In 2018, when the exclusion amount is \$11.18 million, Mike dies with assets of \$3.18 million. Mike's estate is below the exclusion amount, and no federal estate tax is due. Nonetheless, Mike's estate must timely file the federal estate tax return if the estate wants to elect to allow Sarah to utilize the DSUE amount of \$8 million. Otherwise, the \$8 million exclusion amount and corresponding credit is lost.

Practice Note

Regardless of the expiration of the statute of limitations for the predeceased spouse's federal estate tax return and the issuance of a closing letter for the predeceased spouse's estate, the Internal Revenue Service has the authority to audit the predeceased spouse's federal estate tax return in order to determine the correct DSUE amount for the estate of the later deceased spouse.[35]

C. The Federal Gift Tax

1. Taxable Gifts

Taxable gifts generally are total gifts made during the calendar year less certain exclusions and deductions.[36] Taxable gifts are reported on the federal gift tax return (Form 709[37]), which generally is due at the same time as the donor's federal income tax return.[38] For each succeeding calendar year, the federal gift tax is computed on a cumulative basis.[39]

Example

In 2016 (year one), T makes $100,000 of taxable gifts to E. In 2017 (year two), T makes $200,000 of taxable gifts to G. For year one, T files a federal gift tax return showing $100,000 of taxable gifts. For year two, T files a federal gift tax return showing $100,000 of taxable gifts for year one and $200,000 of taxable gifts for year two. For year two, the tentative gift tax (i.e., the gift tax before the application of the applicable credit amount) is the difference between the tentative gift tax computed on the sum of (1) the $100,000 of taxable gifts and (2) the $200,000 of taxable gifts and the tentative tax computed on the $100,000 of taxable gifts. In this scenario, no gift tax is due because of the application of the applicable credit amount available in year one and remaining for year two.

Gifts are not limited to outright transfers. A gift can be a transfer to a trust. A gift also can be in the form of the exercise, release, or lapse of a "general power of appointment" by the holder of the power.[40] For a further discussion of powers of appointment, please refer to Chapter 3.

2. Annual Exclusion

A donor may make gifts qualifying for the annual exclusion under Code section 2503(b). The annual exclusion allows for the exclusion of $10,000 per donee from taxable gifts.[41] This dollar amount of $10,000 is indexed for inflation, in multiples of $1,000, beginning in 1999.[42] For 2018, the first $15,000[43] of a gift a donor makes to a donee[44] during the calendar year is excluded from taxable gifts. There is no limit on the number of annual exclusion gifts that the donor may make during the calendar year, nor is there any requirement that the recipients be related to the donor. In addition, an annual exclusion gift need not be given at one time.

Example

A donor transfers $5,000 on January 31, 2018, $4,500 on March 8, 2018, and $5,500 on October 22, 2018, to the same donee. The transfers qualify for the annual exclusion of $15,000 per donee.

Only gifts of present interests qualify for the annual exclusion.[45] Transfers of assets considered future interests—that is, interests that the donee or beneficiary cannot enjoy currently—do not qualify for the annual exclusion. The Treasury Regulations provide that "an unrestricted right to the immediate use, possession, or enjoyment of principal or income is a present interest," whereas a future interest, a "legal term," is "limited to commence in use, possession, or enjoyment at some future date or time."[46] An outright transfer constitutes a present interest. Whether a transfer in trust is a present interest or a future interest depends on the rights of the beneficiary. For example, a transfer in trust wherein the beneficiary receives an "immediate interest" in trust income creates a present interest. An interest in trust income is "immediate" if the beneficiary has a current right to trust income.[47] On the other hand, a transfer in trust in which distributions of income are in the discretion of the trustee constitutes a gift of a future interest that would not qualify for the annual exclusion.[48]

Example

In 2018, a donor pays a life insurance premium in the amount of $15,000 on a policy owned outright by the donee. This payment qualifies for the donor's annual exclusion.

Example

In 2018, a donor transfers $15,000 to a trust for payment of a life insurance premium on a policy owned by the trust. The beneficiary of the trust does not have a present interest in the trust because the trust provisions provide that the trustee has the discretion to distribute income to the beneficiary. The transfer of $15,000 does not qualify for the donor's annual exclusion because the $15,000 is not a gift of a present interest. Certain transfers in trust, however, may qualify for the annual exclusion. Chapter 3 (relating to lifetime gifts to minors) and Chapter 4 (relating to the use of life insurance in planning for minors) explain the trust requirements for qualification of the transfer for the annual exclusion.

No gift tax return need be filed if only annual exclusion gifts are made, unless gift splitting is elected, although there may be good reasons to file anyway.[49] A married couple[50] may elect to split gifts—that is, to treat gifts by one spouse as if the gifts had been made one-half by each of them to a third party. If gift splitting is elected, all gifts must be split—the couple cannot pick and choose which gifts to split.[51] To elect gift splitting, each spouse generally files a gift tax return consenting to the gift split.[52]

Practice Note

By gift splitting,[53] a married couple effectively is allowed to double the amount of annual exclusion gifts *each* makes in a calendar year to as many individuals as they want, even though the gift is made entirely out of one spouse's separate property.[54]

The following examples illustrate the interaction of annual exclusion gifts, gift splitting, and/or federal gift tax return filing requirements.

Example

In 2018, a donor makes a cash gift of $15,000 to a child and makes no additional gifts to the child (or to any trust for the child's benefit) during the calendar year. This gift utilizes the donor's annual exclusion, and no federal gift tax return need be filed.

Example

In 2018, a donor makes a cash gift of $15,000 to each of her two children, totaling $30,000, and makes no additional gifts to either child (or to any trust for either child's benefit) during the calendar year. These gifts utilize the donor's annual exclusions, and no federal gift tax return need be filed.

Example

In a community property state, a husband and wife make a cash gift of $30,000 to a child in 2018. Because gifts of community property are treated as being made one-half by each of the husband and the wife, the gift is actually two $15,000 gifts to the child, one by the husband and one by the wife. Assuming neither husband nor wife makes any other gifts to the child (or to any trust for the child's benefit) in that calendar year, the gifts qualify for the husband's and wife's annual exclusion, and no federal gift tax returns need be filed.

Example

In a noncommunity property state, a husband makes a cash gift of $30,000 to a child in 2018. This may be reported in either of two ways. First, this may be treated as a gift of $30,000 by the husband to the child, of which $15,000 would qualify for the husband's annual exclusion, and $15,000 would use part of the husband's applicable exclusion amount. This gift would need to be reported on the husband's federal gift tax return because he made gifts over and above his annual exclusion. Alternatively, the husband and wife could "split" the gift. In that case, the gift would be treated as a gift of $15,000 by each of the husband and wife, but federal gift tax returns would need to be filed by each spouse for consent to the gift splitting.

Example

In a noncommunity property state, a husband makes a gift of $30,000 to his child, and his wife makes a gift of $300,000 to her sister in 2018. If gift splitting is elected, each spouse is treated as making a gift of $15,000 to the child and $150,000 to the wife's sister. Even though the husband may not desire to utilize his applicable exclusion amount[55] on gifts to his wife's sister, if he wants to split the $30,000 gift with his wife, he also must split the $300,000 gift with her. Either all gifts in a single calendar year must be split, or none.

3. *Excluded Transfers under Code Section 2503(e)*

In addition to the annual exclusion, the Code excludes certain transfers, referred to as "qualified transfers," from taxable gifts and, therefore, from federal gift taxation. These qualified transfers are:

- Direct payment of tuition by the donor to the educational institution, on behalf of any individual, whether or not related to the donor.[56]

Example

On behalf of his child, a donor makes a direct payment to the college for his child's books and housing at college. The payment does not meet the requirements of section 2503(e) because the direct payment is not for tuition.[57]

Example

A donor gives his friend $20,000 for payment of tuition at graduate school. The transfer does not meet the requirements of section 2503(e) because the donor did not make the payment directly to the graduate school.[58]

- Direct payment of medical expenses to the medical provider on behalf of an individual, whether or not related to the donor, receiving medical care.[59] These medical expenses include amounts paid for medical insurance but not for expenses reimbursed by the insurer.[60]

Example

A donor transfers $600 to her child for payment of her child's medical premiums. The transfer does not meet the requirements of section 2503(e) because there is no direct payment to the insurer.

Example

A donor directly pays a medical provider for her child's medical treatment in the amount of $1,000. The insurer reimburses 80 percent of the $1,000 payment. Only $200 (20 percent of $1,000) is a qualified transfer under Code section 2503(e).[61]

The following example illustrates the interrelationship between qualified transfers under section 2503(e), the annual exclusion, and the applicable exclusion amount:

Example

In 2018, a donor makes payments totaling $50,000 as follows: An amount of $10,000 is paid directly to his child's grammar school for tuition. Since the amount of $10,000 is paid directly to the educational institution for tuition, $10,000 (constituting the qualified transfer) is excluded from taxable gifts under section 2503(e). The remainder ($40,000) he gives directly to his child. Of this, $15,000 is excluded from being a taxable gift by reason of the annual exclusion. The remaining $25,000 is a taxable gift, which is reported on the donor's federal gift tax return, and utilizes part of the donor's applicable exclusion amount. If this is the first taxable gift the donor has ever made, his applicable exclusion amount remaining for gifts in later years is reduced by $25,000. (Taxable gifts automatically reduce the donor's applicable exclusion amount. The donor does not have the option to pay the gift tax on the $25,000 taxable gift and keep his applicable exclusion amount intact to be used against future taxable gifts during his lifetime or to be used at his death.)

4. Federal Gift Tax Marital Deduction

A gift tax marital deduction effectively allows for lifetime transfers between spouses[62] without imposition of federal gift taxation, but only if the donee spouse is a U.S. citizen.[63]

The following example illustrates the mechanics of the applicable exclusion amount and the marital deduction during lifetime:

EXAMPLE

Assuming a married individual's applicable exclusion amount is $11.18 million, a married individual makes taxable gifts of $11.18 million to his children (or others) without being subject to federal gift taxes in 2018. Despite no available applicable exclusion amount, the married donor, in the same year, also may make taxable gifts (i.e., gifts less annual exclusion amounts and any Code section 2503(e) qualified transfers) in any amount to his U.S. citizen spouse without incurring any federal gift tax because of the availability of the gift tax marital deduction.

D. The Federal Estate Tax

1. Gross Estate

A federal estate tax is imposed on the "taxable estate" of the decedent. The "taxable estate" is the gross estate less authorized deductions.[64] The decedent's gross estate includes assets in which the decedent held an interest at date of death.[65] These assets typically include what are considered the probate assets passing under the decedent's will (e.g., a fee interest in real estate, a tenant in common interest in real estate, an automobile or other tangible personal property owned solely by the decedent, stock or other intangible personal property owned solely by the decedent, or an insurance policy owned solely by the decedent on the life of another without a beneficiary designation). The gross estate for federal estate tax purposes also may include the following:[66]

- the proceeds of life insurance on the life of the decedent;[67]
- retirement benefits payable to beneficiaries;
- certain annuities;[68]
- the decedent's interest in jointly held property;[69]

- relinquishment of a power under Code sections 2036, 2037, or 2038 (see below) "during the 3-year period ending on the decedent's date of death";[70]
- transfer of a life insurance policy that would have been includable in the decedent's gross estate under Code section 2042, "during the 3-year period ending on the decedent's date of death";[71]
- gift tax paid by the decedent or his or her estate "on any gift made by the decedent or his or her spouse during the 3-year period ending on the date of the decedent's death";[72]
- certain powers or rights over assets held by a decedent at death. These powers or rights are set forth in Code sections 2036, 2037, 2038, and 2041.

Under Code section 2036, the decedent's gross estate includes any interest the decedent transferred (for example, by gift) during his or her lifetime, but (1) of which he or she retained possession or enjoyment; (2) from which he or she retained the right to the income from the asset; or (3) over which he or she retained the right to designate who may possess or enjoy the asset or the income therefrom.

Example

During his lifetime, A transfers stocks and bonds to a trust for the benefit of his child, but retains the right to the income from the stocks and bonds for the life of A. The stocks and bonds are included in A's gross estate.[73]

Under Code section 2037, the decedent's gross estate includes property the decedent transferred, but retained a reversionary interest exceeding 5 percent of the value of the property immediately before the decedent's date of death.

Example

During his lifetime, B transfers property to a trust. The trust document provides income to his wife for life, remainder payable to B and, if B is not living at his wife's death, to his child or child's estate. Assuming B's reversionary interest immediately before his death exceeds 5 percent of the value of the property, the value of the property, less the wife's outstanding life estate, is included in B's, the decedent's, gross estate.[74]

Under Code section 2038, the decedent's gross estate includes property the decedent transferred but has the power to alter or amend.

Example

During his lifetime, C transfers stocks and bonds to a trust for the benefit of his children, but retains the right to designate who should receive the income. Under Code section 2038, the income interest is includable in C's, the decedent's, gross estate.[75]

Under Code section 2041, the decedent's gross estate includes any property over which the decedent held, at his or her death, a "general power of appointment." A general power of appointment, for federal estate tax purposes, is the power to designate that property (typically but not necessarily owned by a trust) to the decedent, the decedent's creditors, the decedent's estate, or creditors of the decedent's estate.[76] Property over which the decedent holds a special power of appointment—that is, one limited by an ascertainable standard—is not included in the decedent's gross estate.[77]

PRACTICE NOTE

Whether a power of appointment is limited by an ascertainable standard is strictly construed. It is prudent to use statutory language or the language set forth in the regulations in drafting a special power of appointment.[78]

2. *Federal Estate Tax Deductions*

(a) Federal Estate Tax Marital Deduction

The Code also allows for an unlimited[79] marital deduction for property passing at death from the decedent to the surviving spouse,[80] if the surviving spouse is a U.S. citizen.[81] If the surviving spouse is not a U.S. citizen, the deduction is not allowed unless the transfer is to a specialized trust known as a qualified domestic trust (QDOT).[82] Note, however, that the assets qualifying for the marital deduction will be subject to federal estate tax upon the surviving spouse's subsequent death, so the marital deduction delays, but does not eliminate, federal estate tax on the death of the first spouse to die.[83]

(b) Deduction for Administration Expenses

Assuming the requirements of Code sections 2053 and 2054 are met, expenses, indebtedness, certain taxes, and losses of the decedent's estate are deductible on the federal estate tax return. One common example is funeral expenses.[84]

(c) State Death Tax Deduction

A decedent's gross estate may be reduced by state estate, inheritance, legacy, or succession tax paid.[85] At the state level, there has been a recent trend to either eliminate these taxes or to raise their exemption levels, which may be due in part to the repeal of the state death tax credit. Please see Chapter 2 for further discussion of this topic.

3. *The Concept of the Credit Shelter Trust*

If a married person passes away and the survivor is a U.S. citizen, the simplest way to defer federal estate tax arguably is to leave everything to the survivor, delaying payment of federal estate taxes until the survivor's death. Especially before the introduction of portability and the increased inflation-adjusted exclusion amounts, practitioners, in many cases, determined that doing so actually increased the total estate taxes required to be paid at the survivor's death.

This concept may be illustrated by reference to a hypothetical married couple,[86] each of whom has a net worth of $7.5 million. Suppose that the husband died in 2016, when the exclusion amount was $5.45 million, and the widow dies in 2018, when the exclusion amount is $11.18 million. Assume the husband's executor does not elect portability for his unused exclusion amount. Assume also no taxable transfers by either spouse took place during lifetime.

If the husband left his entire estate to his wife, there would be no estate tax at his death since his estate passed to his surviving U.S. citizen spouse. That is, use of the marital deduction reduced the husband's taxable estate to zero, as reflected in column one of scenario one, which follows. However, at the widow's subsequent death in 2018, her estate would amount to $15 million (assuming no change in value), and her exclusion amount would be $11.18 million, leaving $3,820,000 taxable. Federal estate taxes would be $1.528 million. Note that the husband's exclusion amount (and corresponding credit) was never used at his death nor was the unused amount utilized at the widow's death.

Scenario One

Husband dies in 2016		**Wife dies in 2018**	
Gross estate	$7,500,000	Gross estate	$15,000,000
Marital deduction	($7,500,000)	Marital deduction	N/A
Taxable estate	$0	Taxable estate	$15,000,000
Tentative estate tax per I.R.C. § 2001(b)(1)	$0	Tentative tax per I.R.C. § 2001(b)(1)	$5,945,800
Unified credit calculated per I.R.C. § 2001(c)	N/A	Unified credit calculated per I.R.C. § 2001(c)	($4,417,800)
Estate tax due	$0	Estate tax due	$1,528,000

In order to avoid estate taxes at his death, the husband only had to leave his wife $2.05 million, which is the amount by which his estate ($7.5 million) exceeded his basic exclusion amount ($5.45 million). He may have left the remaining $5.45 million of assets in trust for his wife. This trust commonly is known as a credit shelter trust or bypass trust. Especially before the availability of the portability election and higher exclusions, the credit shelter trust was a commonly used estate planning tool.

The credit shelter trust could provide the wife with benefits during her lifetime, but would not be treated as part of her taxable estate and would pass to the couple's children tax-free when the wife passed away. At her death, the wife's taxable estate would have amounted to $9.55 million (her

$7.5 million plus the $2.05 million inherited from her husband) rather than the $15 million amount that occurs if the husband leaves his entire estate to his wife. At her death in 2018, the wife's estate tax credit would shelter all of her $9.55 million estate; none of it would have been taxable. Her estate tax liability would have amounted to over $1,528,000 less in taxes than would have occurred had the husband left his entire estate to his wife.[87]

The $2.05 million bequest to the wife could have been outright or in a special trust known as a marital trust. While an outright bequest is simpler, the use of a marital trust for the widow's bequest may offer her protection from creditors, as well as from claims of a future spouse, if any, and can help ensure that the trust property eventually passes to the intended beneficiaries.

Scenario Two

Husband dies in 2016		**Wife dies in 2018**	
Gross estate	$7,500,000	Gross estate	$9,550,000
Marital deduction	($2,050,000)	Marital deduction	N/A
Taxable estate	$5,450,000	Taxable estate	$9,550,000
Tentative estate tax per I.R.C. § 2001(b)(1)	$2,125,800	Tentative tax per I.R.C. § 2001(b)(1)	$4,165,800
Unified credit calculated per I.R.C. § 2001(c)	($2,125,800)	Unified credit calculated per I.R.C. § 2001(c)	($4,417,800)
Estate tax due	$0	Estate tax due	$0

Practice Note

Despite the availability of portability,[88] practitioners, depending on the client's specific circumstances, may continue to recommend use of credit shelter planning or disclaimer trust planning.[89]

4. Basis Consistency and Reporting

Generally, the basis of property acquired from the decedent or to whom property passed from the decedent is the property's fair market value on the decedent's date of death or the alternate valuation date, if elected.[90] For property with respect to a federal estate tax return filed after July 31, 2015, consistent basis may be required under Code section 1014(f).[91] That is, the basis of property in the hands of a person inheriting the property from the decedent must not exceed the final value determined for federal estate taxation purposes and, if not determined, the value identified on a statement required under Code section 6035(a).[92] In addition to basis consistency, the estate may be required to satisfy certain reporting requirements, namely,

1. file an information return (i.e., Form 8971,[93] including copies of Schedule A for each beneficiary) with the Internal Revenue Service and
2. furnish a statement (i.e., Schedule A of Form 8971) to each beneficiary who has or will receive property from the estate.[94]

The information return generally is required to be filed with the Internal Revenue Service and the statement is required to be furnished to each beneficiary on or before the *earlier* of (1) thirty days after the due date of the filing of the federal estate tax return (including extensions actually granted) or (2) thirty days after the date the federal estate tax return is filed.[95] Penalties may be imposed for failure to file a timely and complete information return and statements.[96] In addition, accuracy-related penalties under Code section 6662 may be imposed for utilizing a basis inconsistent with the federal estate tax value of the property.[97]

The basis consistency requirement only applies to property includable in the decedent's gross estate for federal estate tax purposes and results in an increased federal estate tax before application of the applicable credit amount.[98]

EXAMPLE

Property qualifying for the marital deduction does not generate estate tax liability and, therefore, is excluded from property subject to the basis consistency requirements of Code section 1014(f).[99] Nonetheless, the basis must be reported pursuant to Code section 6035.[100]

Property excluded from reporting includes:

1. Cash "(other than a coin collection or other coins or bills with numismatic value),"
2. Income in respect of the decedent (as defined in Code section 691),
3. Tangible personal property for which an appraisal is not required under Regulation section 20.2031-6(b) "(relating to valuation of certain household goods and personal effects),"[101] and
4. Property "sold, exchanged, otherwise disposed of (and therefore not distributed to the beneficiary) by the estate in a transaction in which capital gain or loss is recognized."[102]

PRACTICE NOTE

Basis reporting requirements also do not apply to federal estate tax returns solely filed for the portability election or a GST allocation.[103]

E. Federal Generation-Skipping Transfer Tax

1. Theory of Federal Generation-Skipping Transfer Tax

As a matter of tax policy, it is Congress's goal to collect either a gift tax or an estate tax once per generation as assets pass from parents to children to grandchildren. From a congressional viewpoint, there is a major problem with the estate and gift tax system: Taxpayers can structure lifetime gifts or bequests at death in a way that only one tax is collected, even though the property "moves down" several generations. For example, a grandparent can make a taxable gift to his or her grandchild at the cost of a single gift tax, even though the property has moved down two generations. A testator could leave property to a trust for his or her descendants at the cost of a single estate tax even though the trust benefits children, grandchildren, and great-grandchildren.

The GST tax is Congress's attempt to collect a tax once per generation. For example, assume that a grandparent makes a taxable gift to his or her grandchild. A GST tax will be imposed *in addition to* the gift tax. The combined cost of both taxes essentially is equal to the total taxes that would have been incurred had the grandparent made a taxable gift to his or her child and the child in turn made a taxable gift to the grandchild. If an estate plan leaves property to a trust for the benefit of children, grandchildren, and great-grandchildren, only one tax will be incurred when the testator passes away. However, on the child's subsequent death, a GST tax will be imposed *as if* the property in the trust were part of the child's estate.

2. *Federal Generation-Skipping Transfer Tax Rate*

The GST tax is imposed at the highest marginal estate tax rate in effect at the time the property is treated as passing from the child to the grandchild.[104] Currently, the GST tax rate is 40 percent.[105]

3. *Federal Generation-Skipping Transfer Tax Exemption*

Each individual has a $10 million exemption amount, indexed for inflation, from GST tax.[106] For 2018, the inflation-adjusted amount, like the basic exclusion amount for estate and gift taxes, is $11,180,000.[107] The GST exemption is scheduled to return to $5 million, indexed for inflation, but based upon the chained consumer price index.[108] Portability does *not* apply to an individual's unused GST tax exemption.[109]

4. *Mechanics of Federal Generation-Skipping Transfer Tax*

The GST tax is imposed on any transfer to a "skip person." A skip person is any individual who is assigned to a generation that is two or more generations younger than the generation of the transferor.[110] For transfers to relatives, generation assignment is based on the family tree. Thus, a child is one generation younger than the transferor. A grandchild is two generations younger than the transferor and hence a skip person. For individuals who are not related to the transferor or to the transferor's spouse, the generation assignment is determined by comparing the date of birth of the transferee to that of the transferor. Nonrelatives who are more than thirty-seven and a half years younger than the transferor are skip persons.[111] A trust is a skip person if all beneficiaries holding a present interest in the trust are skip persons.[112] Thus, a trust exclusively for grandchildren is a skip person, and a transfer to that trust would trigger a GST tax. A trust for children and grandchildren is not a skip person, and a transfer to that trust does not trigger a GST tax. However, a distribution of income or principal from the trust to a grandchild during the life of the child would constitute a taxable distribution subject to the GST tax. Similarly, the death of the child survived by issue (irrespective of whether the trust then terminates or the trust principal is retained in further trust for the grandchildren) constitutes a taxable termination subject to the GST tax. As can be seen from these examples, the GST tax is imposed when benefits actually pass to the grandchildren's generation.

Automatic Allocation. GST tax exemption is allocated automatically to gifts to skip persons, as well as to some trusts in which skip persons have an interest, unless the transferor files a timely federal gift tax return and opts out of the automatic allocation.[113]

II. FUNDAMENTAL PRINCIPLES OF FEDERAL INCOME TAXATION PERTAINING TO MINORS

Two aspects of federal income taxation are commonly relevant to planning for passing wealth to minors: income taxation of the minor and income taxation of irrevocable trusts for the benefit of minors.

A. Federal Income Taxation of Minors

Like adults, minors can be subject to federal income tax. Minors may be taxed at the same rates as other individuals unless the kiddie tax, discussed next, applies. A minor's gross income for federal income tax purposes excludes qualified scholarships and qualified tuition reductions, as defined by Code section 117.

The kiddie tax allows for the unearned income (i.e., dividends, interest, other investment income) over and above an inflation-adjusted threshold amount[114] ($2,100[115] in 2018) of a child who is under the age of nineteen (or, if a full-time student, under the age of twenty-four) to be calculated differently from other individual taxpayers. For tax years before 2018, this unearned income, in effect, was subject to the greater of the child's rate or the parent's or parents' top marginal tax rate.[116] For tax years beginning after December 31, 2017, and before January 1, 2026, this unearned income generally is subject to the income tax rates and brackets applicable to trusts and estates.[117] For tax year 2018, trust and estate income from interest and short-term capital gains is taxed at the following rates:

If interest income and short-term capital gains are . . .	The tax is . . .
Not over $2,550	10% of the taxable income
Over $2,550 but not over $9,150	$255 plus 24% of the excess over $2,550
Over $9,150 but not over $12,500	$1,839 plus 35% of the excess over $9,150
Over $12,500	$3,011.50 plus 37% of the excess over $12,500

Although subject to compressed income thresholds, long-term capital gains and "qualified dividends" are subject to tax at their current favorable rates as follows:[118]

If long-term capital gains and "qualified dividends" are . . .	The tax is . . .
Not over $2,599	0%
Over $2,599 but not over $12,700	15%
More than $12,700	20%

PRACTICE NOTE

The purpose of the kiddie tax is to prevent parents from reducing their income tax by transferring income-producing property to their children and using their children's lower income-tax brackets. In calculating the kiddie tax with the temporary application of the trusts and estate tax rates and brackets, some commentators, however, are finding that the deterrent effect on high income parents may be lessened.[119]

B. Federal Income Taxation of Irrevocable Trusts for the Benefit of Minors[120]

Children are often the beneficiaries of irrevocable trusts created for their benefit by parents or grandparents. The Code essentially divides irrevocable trusts into two categories: non-grantor trusts and grantor trusts. Non-grantor trusts are treated as separate taxpayers for federal income tax purposes. In general, a non-grantor trust pays federal income taxes on its taxable income if that income is not distributed to the beneficiaries during the calendar year. To the extent that its taxable income is distributed to the beneficiaries, such beneficiaries are responsible for the income taxes. Grantor trusts are not treated as separate taxpayers. Instead, all items of income, deduction, and credit are reported on the federal income tax return of the trust's grantor or settlor.

1. Non-Grantor Trusts

Income from assets owned by non-grantor trusts either is taxed to the trust itself or is reported as a deduction to the trust and income to the trust beneficiaries individually, depending on various factors. It often is advantageous to cause the income of a non-grantor trust to be taxed to its beneficiaries in order to take advantage of their income tax brackets.[121] In 2018, a non-grantor trust reaches the maximum 37 percent federal income tax bracket at over $12,500 of taxable income while a single person does not reach that bracket until over $300,000 of taxable income.[122]

A concept unique to federal income taxation of non-grantor trusts is distributable net income, or DNI. In the most general sense, DNI describes the trust's taxable income. To the extent that distributions are made to beneficiaries, DNI is said to be "carried out" by the distribution, with the result that the beneficiary is receiving taxable income. DNI is basically the sum of the trust's ordinary income and tax-exempt income, less various deductions, including amounts distributed to charity. As a general rule, capital gains are not included in DNI and hence are taxed to the trust. However, the trustee may elect to include capital gains in DNI, an action typically associated with a total return trust strategy.[123] Distributions to trust beneficiaries are considered taxable income to the beneficiaries, and deductions to the trust, up to the amount of each beneficiary's share of DNI. The beneficiary's share of DNI is determined by reference to the terms of the trust agreement. Distributions in excess of the beneficiary's share of DNI are neither taxable income to the beneficiary nor deductions to the trust. If distributions to the trust's beneficiaries are less than the trust's DNI, only a portion of the trust's income will be reported by the beneficiaries, and the remainder will be reported by the trust. If distributions to the beneficiaries are equal to or greater than the trust's DNI, all of the trust's income could potentially be reported by the beneficiaries on their individual returns. Exceptions to this general rule exist, of course, so determination of the income tax consequences of any particular distribution should be made by an advisor familiar with all of the subtleties of income taxation of non-grantor trusts.

2. Grantor Trusts

Grantor trusts are irrevocable trusts that are completely valid for state law purposes but that are not recognized as separate taxpayers for federal income tax purposes. Instead, all items of trust income, deduction, and credit are reported on the grantor's personal income tax return, regardless of how or to whom trust income may actually have been distributed. As a general rule, an irrevocable trust is treated as a grantor trust if the grantor (or settlor) retains the power[124] to (1) change beneficiaries, (2) control distributions of income and principal to beneficiaries, (3) deal with the assets of the trust in a nonfiduciary capacity, or (4) utilize trust income or principal for his or her own benefit. An irrevocable trust also may be treated as a grantor trust if a "related or subordinate party"[125] serves as trustee and possesses these powers.

Since the grantor pays the income tax attributable to the grantor trust's taxable income, even though that income is either retained by the trust or distributed to the beneficiaries, the grantor is effectively making a gift to the trust and its beneficiaries. However, payment of the income tax liability may not be treated by the Internal Revenue Service as a gift by the grantor to the trust or its beneficiaries.[126]

Because the grantor and the trust are considered to be one taxpaying entity, sales between the grantor and the trust may not be recognized for federal income tax purposes. This allows the grantor to sell an appreciated asset to a grantor trust without realizing capital gains. Since no gain is recognized, the grantor trust retains the grantor's income tax basis in the property that it purchased. Other transactions between the grantor and the trust that would otherwise be taxable, such as payment of interest or rent, also are ignored for federal income tax purposes.

Irrevocable trusts for minors, including Crummey trusts, often are structured intentionally as grantor trusts in order to maximize the trust's cash flow since the grantor will pay all income taxes attributable to the trust's income.[127] Grantor trusts also are used when the grantor wishes to sell income-producing property to a trust for a minor without realizing capital gains taxes. Such transactions usually are structured as installment sales, and a portion of the property's cash flow is used to debt service the trust's promissory note to the grantor. Finally, a grantor who owns one or more policies of insurance on his or her life may sell those policies in a highly advantageous manner to a grantor trust.[128]

Practice Note

Practitioners and taxpayers also must consider the "net investment income" tax under Code section 1411, effective for tax years after December 31, 2012. This tax is *in addition to* the federal income tax. Individuals with net investment income are subject to a 3.8 percent tax if the single individual's modified adjusted gross income[129] is $200,000 (in the case of married filing jointly, $250,000).[130] Generally, estates and certain trusts[131] with undistributed net investment income also are subject to the tax if adjusted gross income[132] is over $12,500 for tax year 2018.[133] Net investment income includes interest; dividends; annuities; royalties and rents, not derived "in the ordinary course of a trade or business"; and "gains from the sale of stocks and bonds."[134]

NOTES

1. Section 2801 of the Internal Revenue Code provides for a tax on certain gifts and bequests from "covered expatriates." This tax, more akin to an inheritance tax than a transfer tax, is beyond the scope of this chapter.

2. Section references are to the Internal Revenue Code of 1986, as amended, or to regulations issued thereunder, unless otherwise indicated.

3. Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16 (June 7, 2001).

4. For a general overview of the earlier history of the federal transfer tax system, see Joint Committee on Taxation, History, Present Law, and Analysis of the Federal Wealth Transfer Tax System (JCX-108-07) (Nov. 13, 2007), https://www.jct.gov/x-108-07.pdf.

5. *See* Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, § 511, § 521. In increasing the estate tax exemption and decreasing the highest estate tax rate, EGTRRA also increased the GST tax exemption and the GST tax rate. *See id.*; I.R.C. § 2641(a)(1).

6. *See id.* § 521.

7. *See id.* § 901.

8. Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312 (Dec. 17, 2010).

9. Without election of the carryover basis regime, the beneficiaries of the estate generally receive what commonly is referred to as a stepped-up basis (i.e., the fair market value of the property at date of the decedent's death) in the property acquired from the decedent. *See* I.R.C. § 1014(a)(1).

10. *See* Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, § 302, § 303, § 304.

11. American Taxpayer Relief Act of 2012, Pub. L. No. 112–240 (Jan. 2, 2013).

12. *See id.* § 101.

13. An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018, Pub. L. No. 115-97 (Dec. 22, 2017), informally referred to as the Tax Cuts and Jobs Act.

14. For federal tax purposes, the terms "husband," "wife," "spouse," "husband and wife," and "marriage" apply to same sex couples if the individuals are lawfully married under state law, regardless of domicile. *See* United States v. Windsor, 570 U.S. 744, 133 S. Ct. 2675 (2013) (in federal estate tax refund case, USSC ruled Defense of Marriage Act's definition of marriage as between a man and a woman is unconstitutional). *See also* Reg. § 301.7701-18 (generally same; also terms "spouse" and "husband and wife," for federal tax purposes, "do not include individuals who have entered into a registered domestic partnership, civil union, or similar formal relationship not denominated as a marriage under the law of the state, possession, or territory of the United States where such relationship was entered into, regardless of domicile."). *See also* I.R.S. Notice 2017-15; 2017-6 I.R.B. 783 (I.R.S. procedures for recalculating remaining applicable exclusion amount and remaining GST tax exemption, discussed in subsection E.3., to the extent allocation of exclusion or exemption were made while the taxpayer was married to a taxpayer of the same sex).

15. *See* I.R.C. § 2010(c)(2).

16. *Id.* at § 11061.

17. Rev. Proc. 2018-18; 2018-10 I.R.B. 392, § 3.35. For tax years beginning after December 31, 2017, the inflation adjustment is based upon the chained consumer price index (CPI) not the traditional CPI. *See* I.R.C. § 1(f)(3); I.R.C. § 2010(c)(3)(B). Thus, adjustments may be in smaller increments. For up-to-date information regarding inflation-adjusted tax items, the reader usually is referred to the applicable Internal Revenue Service revenue procedure issued near the end of each year. Because of the late enactment of the Tax Cuts and Jobs Act in 2017, the Internal Revenue Service issued additional revenue procedures in the beginning of the year 2018 for certain items impacted by the act.

18. Form 706 and Instructions for Form 706 are available on the IRS website, www.irs.gov.

19. *See* I.R.C. § 6018(a).

20. *See* I.R.C. § 2010(c)(1) (cross-referencing I.R.C. § 2001(c)).

21. *See* note 17.

22. *See* I.R.C. § 2010(c)(3)(A). *See also* I.R.C. § 2010(c)(3)(C).

23. *See* 2017–2018 Priority Guidance Plan, fourth quarter update (Aug. 17, 2018), *available at* www.irs.gov/pub/irs-utl/2017-2018_pgp_4th_quarter_update.pdf.

24. If the estate passes to a U.S. citizen spouse, the marital deduction must be taken, leaving a net estate of zero and no federal estate tax due. Thus, any credits designed to reduce tax are unnecessary. *See* I.R.C. § 2056(a). *See also* subsection D.3. (calculations) of this chapter.

25. *See* note 14.

26. *See* I.R.C. §§ 2010(a), 2010(c)(2)(B).

27. *See* Reg. §§ 20.2010-2(a)(2), 20.2010-3(a)(2). *See also* Form 706 (rev. Nov. 2018), Part 6. Forms and instructions are available on the IRS website, www.irs.gov.

28. *See* Reg. § 20.2010-2(a)(1). A request for a private letter ruling may not be required for those estates below the threshold basic exclusion amount. *See* simplified method in Rev. Proc. 2017-34; 2017-24 I.R.B. 1282 (June 9, 2017) (reinstating simplified method set forth in earlier revenue procedure for obtaining an extension of time to elect portability for estates below the threshold basic exclusion amount "for a period the last day of which is the later of January 2, 2018, or the second anniversary of the decedent's date of death"). *See also* Rev. Proc. 2018-3, § 6.08, 2018-1 I.R.B. 130 (no ruling if request filed before second anniversary of the decedent's date of death and where IRS provided administrative procedure to seek extension).

29. This extension is the extension typically requested for the late filing of a federal estate tax return required to be filed when the gross estate is above the threshold basic exclusion amount. *See* Reg. § 20.6081-1. *See also* I.R.C. § 6075(a); Reg. § 20.6075-1. *See also* Form 4768, Application for Extension of Time To File a Return and/or Pay U.S. Estate (and Generation-Skipping Transfer) Taxes. Forms and instructions are available on the IRS website, www.irs.gov.

30. *See* Reg. § 20.2010-2(a)(4).

31. *See* Reg. § 20.2010-3(a)(1)(ii).

32. *Compare* I.R.C. § 2010(c)(3).

33. *See* I.R.C. § 2631(c). *See also* I.R.C. §§ 2010(a), 2010(c)(2), 2505.

34. *See* note 14.

35. *See* Estate of Sower v. Commissioner, 149 T.C. No. 11 (2017). *See also* I.R.C. § 2010(c)(5)(B); Reg. §§ 20.2010-2(d), 20.2010-3(d).

36. "Adjusted taxable gifts" is the technical term that the Code uses to refer to gifts made after 1976, "other than gifts which are includible in the gross estate of the decedent." *See* I.R.C. § 2001(b) (flush language).

37. Form 709 and Instructions for Form 709 are available on the IRS website, www.irs.gov.

38. I.R.C. § 6075(b). *See also* I.R.C. § 6019(a).

39. *See* I.R.C. §§ 2502(a), 2001(b). *See also* Reg. § 25.2502-1(a).

40. I.R.C. § 2514.

41. I.R.C. § 2503(b)(1).

42. I.R.C. § 2503(b)(2).

43. *See* Rev. Proc. 2017-58, 2017-45 I.R.B. 489, § 3.37(1) (Oct. 19, 2017).

44. If the donee spouse is a non-U.S. citizen, the annual exclusion of $10,000, indexed for inflation, does not apply. Instead, a $100,000 annual exclusion applies. *See* I.R.C. § 2523(i)(2). Like the $10,000 annual exclusion, this exclusion also is indexed for inflation based upon the chained CPI. *See* note 17. For 2018, the amount is $152,000. *See* Rev. Proc. 2017-58, *supra* note 43, § 3.37(2).

45. I.R.C. § 2503(b)(1).

46. *See* Reg. §§ 25.2503-3(b), 25.2503-3(a).

47. *See* Rev. Rul. 75-506, 1975-2 C.B. 375 (applying language contained in current Regulation section 25.2503-3(a)).

48. *See also* Chapter 3.

49. *See* I.R.C. § 6019. Note that there, however, are reasons to report annual exclusion gifts, including record keeping, commencing the statute of limitations for the value of the asset gifted, and allocating GST tax exemption (mentioned later) for annual exclusion gifts transferred to trusts. *See* Chapter 3 (regarding interaction of GST allocation and annual exclusion gifts). *See also* subsection E.4. of this chapter.

50. *See* note 14.

51. I.R.C. § 2513(a)(2).

52. I.R.C. § 2513(a)(2)-(b); *see* Reg. § 25.2513-2 (regarding "[m]anner and time of signifying consent").

53. Gift splitting is available only if, at the time of the gift, each spouse is a citizen or resident of the United States. I.R.C. § 2513(a)(1). Gift splitting also is not available for an interest in property over which the spouse creates a general power of appointment, as defined in Code section 2514(c), for his or her spouse. *See* I.R.C. § 2513(a)(1); Reg. § 25.2513-1(b)(3).

54. I.R.C. § 2513(a).

55. *Id.*

56. I.R.C. § 2503(e)(2)(A).

57. Reg. § 25.2303-6(b)(2).

58. *See additional examples*, Reg. § 25.2503-6(c), Ex. 1 & 2.

59. I.R.C. § 2503(e)(2)(B).

60. *See* Reg. § 25.2503-6(b)(3).

61. *See additional example*, Reg. § 25.2503-6(c), Ex. 3.

62. *See* note 14.

63. I.R.C. § 2523(a).

64. *See* I.R.C. § 2051.

65. *See* I.R.C. § 2033.

66. This is not an exclusive list.

67. *See* I.R.C. § 2042.

68. *See* I.R.C. § 2039.

69. If the surviving joint tenant is a U.S. citizen spouse, one-half of the value of the jointly held property automatically is excluded from the decedent's gross estate. *See* I.R.C. § 2040(b). The federal estate and gift tax implications of property held in joint tenancy with a non-U.S. citizen spouse are beyond the scope of this chapter. *See* Miriam A. Goodman, *Joint Tenancy with a Noncitizen Spouse: An Estate and Gift Tax Guide for the Perplexed*, PROB. & PROP. (Jan./Feb. 2002).

70. I.R.C. § 2035(a).

71. *Id.*

72. I.R.C. § 2035(b).

73. *See* Reg. § 20.2036-1(a)(ii).

74. Reg. § 20.2032-1(e), Ex. 3.

75. Reg. § 20.2038-1(a)(3).

76. Code section 2041(b)(1) specifically states, "[t]he term 'general power of appointment' means a power which is exercisable in favor of the decedent, his estate, his creditors, or the creditors of his estate." *Id.*

77. I.R.C. § 2041(b)(1)(A).

78. *See* I.R.C. § 2041(b)(1)(A); Reg. § 20.2041-1(c)(2). *See also* Chapter 3.

79. Local law and governing instruments (e.g., will) must be reviewed to determine the effect of taking deductions for certain administration expenses and/or state death taxes on the amount of the marital deduction taken on the federal estate tax return. *See* Reg. § 20.2056(b)(4).

80. *See* note 14.

81. I.R.C. § 2056.

82. I.R.C. § 2056(d).

83. I.R.C. § 2044. In addition, certain distributions from a qualified domestic trust are subject to estate taxation during the life of the surviving spouse. *See* I.R.C. § 2056A.

84. *See* I.R.C. §§ 2053(a)(1), 2053(c)(2). *See also* Reg. § 20.2053-2.

85. I.R.C. § 2058(a).

86. *See* note 14.

87. I.R.C. § 2011(f).

88. *See* subsection 1.B.3. of this chapter.

89. A disclaimer trust may be designed to allow the decedent's gross estate to pass to the surviving spouse with the surviving spouse having the option of disclaiming assets to the credit shelter trust. Disclaimer trust planning is beyond the scope of this chapter. For further information, including the impact of portability on estate planning, see S. Andrew Pharies, *Portability: The Basics and Beyond*, 21 ALI-CLE Est., Plan., Course Materials J. 45 (2015).

90. *See* I.R.C. § 1014(a). *See also* I.R.C. § 2032.

91. *See* I.R.C. § 1014(f), added by the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015, Pub. L. No. 114-41, § 2004(a) (July 31, 2015). Code section 1014(f) applies to property to which a federal estate tax return is filed after July 31, 2015. *See id*. § 2004(d). Note that the basis becomes relevant for federal income tax purposes in calculating depreciation or gain or loss on the sale of the property.

92. *See* I.R.C. § 1014(f)(1).

93. Forms and instructions are available on the IRS website, www.irs.gov.

94. *See* Prop. Reg. § 1.6035-1(a), 1.6035-1(g)(2) and (3). *See also* I.R.C. § 6035(a), added by Pub. L. No. 114-41, *supra* note 91, § 2004(b)(1).

95. *See* Prop. Reg. § 1.6035-1(d)(1). *See also* I.R.C. § 6035(b). The Internal Revenue Service, however, repeatedly delayed the due date for the reporting requirements. *See* Notice 2015-57, 2015-36 I.R.B. 294; Notice 2016-19, 2016-9 I.R.B. 362; T.D. 9757, REG 127923-15 (temporary and proposed regulations); Notice 2016-27, 2016-9 I.R.B. 362. Final regulations eventually provided that "[e]xecutors and other persons required to file or furnish a statement under [Code] section 6035(a)(1) or (2) after July 31, 2015 and before June 30, 2016, need not have done so until June 30, 2016." *See* Reg. § 1.6035-2(a).

96. *See* I.R.C. §§ 6721, 6722. *See also* Prop. Reg. § 1.6035-1(h). Penalties may be waived due to reasonable clause. *See* I.R.C. § 6724.

97. *See* I.R.C. § 6662(a). *See* I.R.C. § 6662(b)(8), (k), added by Pub. L. No. 114-41, *supra* note 91, § 2004(c). *See also* Prop. Reg. § 1.6662-8. Property later discovered or omitted from the federal estate tax return also may be subject to a zero basis. *See* Prop. Reg. § 1.1014-10(c)(3).

98. *See* I.R.C. § 1014(f)(2). *See also* Prop. Reg. § 1.1014-10(b).

99. *See* Prop. Reg. § 1.6035-1(a)(2).

100. *See* Prop. Reg. §§ 1014-10(b)(2), 1.6035-1(b).

101. This property also is excluded from property subject to the basis consistency requirement. *See* Prop. Reg. § 1014-10(b)(2).

102. *See* Prop. Reg. § 1.6035-1(b).

103. *See* Prop. Reg. § 1.6035-1(a)(2).

104. *See* I.R.C. § 2641(a)(1).

105. *See* I.R.C. § 2641(b) (cross-referencing I.R.C. § 2001(c)).

106. *See* I.R.C. § 2631(c) (GST exemption amount same as basic exclusion amount).

107. *See id. See also* note 17.

108. *See* notes 17 and 21.

109. *See* note 33.

110. I.R.C. § 2651. *See also* I.R.C. § 2613(a)(1).

111. *See* I.R.C. § 2613(d)(2).

112. *See* I.R.C. §§ 2613(a)(2)(A), 2613(a)(1).

113. *See* I.R.C. § 2632(a)(2); Reg. § 26.2632-1(b)(1).

114. *See* I.R.C. § 1(g).

115. *See* I.R.C. § 1(g)(4)(A)(ii) (cross-referencing I.R.C. § 63(c)(5)(A)). *Id. See also* Rev. Proc. 2018-18, *supra* note 17, § 3.14(2).

116. *See* I.R.C. § 1(g)(1).

117. *See* I.R.C. § 1(j)(4) (cross-referencing I.R.C. § 1(j)(2)(E)), added by Pub. L. No. 115-97, § 11001(a), *supra* note 13.

118. *See* I.R.C. § 1(j)(4)(A) and (C), added by Pub. L. No. 115-97, § 11001(a), *supra* note 13. *See also* Jonathan Curry, *"More Than Meets the Eye" to TCJA's Kiddie Tax Tweak*, TAX NOTES 1 (June 11, 2018). For tax years beginning January 1, 2019, estates and trust brackets for interest income and short-term capital gains are adjusted for inflation each year based upon the chained consumer price index. *See* I.R.C. § 1(j)(3)(B) (cross-referencing I.R.C. § 1(f)), added by Pub. L. No. 115-97, § 11001(a), *supra* note 13. Public Law 11-97 (i.e., informally referred to as The Tax Cuts and Jobs Act) did not affect rates for long-term capital gains and "qualified dividends," but changed the income thresholds for these items. *See* I.R.C. § 1(h). *See also* I.R.C. § 1(j)(5), added by Pub. L. No. 115-97, § 11001(a), *supra* note 13.

119. *See, e.g.*, Samuel D. Brunson, *Meet the New 'Kiddie' Tax: Simpler and Less Effective*, TAX NOTES (Sept. 3, 2018).

120. What follows is a gross simplification of an extraordinarily complex topic. It is designed to provide the reader with an overview of taxation of trusts and their beneficiaries. Multivolume works could be—and have been—written on this complex topic.

121. For tax years beginning after December 31, 2017, and before January 1, 2026, this strategy may require reconsideration for minor beneficiaries in light of the amendments to the kiddie tax. *See* subsection II.A. of this chapter.

122. *See* Rev. Proc. 2018-18, *supra* note 17, § 3.01. *See also* I.R.C. § 1(j)(2)(E).

123. A total return strategy refers to a trust that provides for distribution to beneficiaries of a fixed annual percentage return, payable without regard to the accounting income of the trust.

124. The grantor trust rules are found in I.R.C. §§ 671–679.

125. Generally, the "related or subordinate party" is the grantor's spouse, if living with the grantor; the grantor's parent; the grantor's issue; the grantor's sibling; or the grantor's employee. *See* I.R.C. § 672(c).

126. Rev. Rul. 85-13, 1985-1 C.B. 184. *But see also* PLR 9444033, subsequently "corrected" by PLR 9543049, and PLR 199922062. *See also* I.R.C. §§ 6110 (b)(1)(A), 6110 (k)(3) (unless otherwise established by regulation, ruling may not be used or cited as precedent). *See also* Rev. Rul. 2004-64, 2004-2 C.B. 7. Depending on the terms of the trust and applicable state law, the trust assets, nonetheless, may be includable in the grantor's gross estate for federal estate tax purposes. *See id.*

127. *Compare* Chapter 4 (irrevocable life insurance trust usually not designed to generate taxable income).

128. *See also* Chapter 4, notes 60–66 and accompanying text.

129. *See* I.R.C. § 1411(d).

130. *See* I.R.C. §§ 1411(a)(1), 1411(b).

131. In the case of a grantor trust, the grantor, not the grantor trust, is subject to the 3.8 percent tax, if applicable. *See* Reg. § 1.1411-3(b)(1)(v).

132. *See* I.R.C. § 1411(a)(2)(i) (cross-referencing § 67(e)).

133. *See* I.R.C. § 1411(a)(2); I.R.C. § 1(e). *See also* Rev. Proc. 2018-18, *supra* note 17, § 3.01. Inflation adjustment is based upon the chained consumer price index. *See* note 17.

134. *See* I.R.C. § 1411(c)(1)(A)(i). *See also* Reg. § 1.1411-4.