

Part I

Section 2519.--Dispositions of Certain Life Estates.

26 CFR 25.2519-1: Dispositions of certain life estates.
(Also sections 2044; 2056; 2511; 2512; 20.2044-1; 20.2056(b)-7;
25.2511-1; 25.2512-8)

Rev. Rul. 98-8

ISSUE

What are the gift tax consequences to the surviving spouse of the acquisition by the surviving spouse of the remainder interest in a trust subject to a qualified terminable interest property (QTIP) election under § 2056(b)(7) of the Internal Revenue Code?

FACTS

The decedent, D, died in 1993 survived by S, D's spouse. Under the terms of D's will, a trust (the QTIP Trust) was established under which S was to receive all of the trust income, payable at least annually, for S's life. On S's death, the remainder was to be distributed outright to C, D's adult child.

S was not given a general power of appointment over the trust property.

On the federal estate tax return filed for D's estate, the executor made an election under § 2056(b)(7) to treat the trust property as QTIP, and a marital deduction was allowed to D's estate for the value of the property passing from D to the QTIP Trust.

Subsequently, S, C, and the trustee of the QTIP Trust entered into the following transaction: (1) S acquired C's remainder interest in the QTIP Trust; (2) S gave C a promissory note in the face amount of x dollars (the value of the remainder interest) for the remainder interest; (3) the trustee distributed all of the QTIP Trust assets (having a value of x + y dollars) to S; and (4) S thereupon paid x dollars from those assets to C in satisfaction of the promissory note.

At the conclusion of the transaction, the QTIP Trust was terminated; S held QTIP Trust assets having a value of y dollars (which was equal to the value of S's life interest in the trust); and C held assets having a value of x dollars (which was equal to the value of the remainder interest in the trust). S contended that the transaction was not subject to gift tax because S received full and adequate consideration (the x dollar remainder interest in the QTIP Trust) in exchange for the x dollar promissory note given by S TO C.

LAW AND ANALYSIS

Section 2044(a) provides that the value of the gross estate includes the value of any property described in § 2044(b) in which the decedent had a qualifying income interest for life. Section 2044(b) provides that § 2044 applies to any property if a deduction was allowed with respect to the transfer of the property to the decedent under § 2056(b)(7).

Section 2056(a) provides that the value of the taxable estate is, except as limited by § 2056(b), determined by deducting from the value of the gross estate an amount equal to the value of any interest in property that passes or has passed from the decedent to the surviving spouse.

Under § 2056(b)(1), if an interest passing to the surviving spouse will terminate, no deduction is allowed with respect to such interest if, after termination of the spouse's interest, an interest in the property passes or has passed (for less than an adequate and full consideration in money or money's worth) from the decedent to any person other than the surviving spouse (or the estate of such spouse).

Section 2056(b)(7)(A) provides that qualified terminable interest property, for purposes of § 2056(a), is treated as passing to the surviving spouse, and no part of such property is treated as passing to any person other than the surviving spouse. In general, qualified terminable interest property is property in which the spouse receives a qualifying income interest for life,

and with respect to which the executor makes an election to treat the property as QTIP.

Section 2511(a) provides that the gift tax applies whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible.

Section 2512(b) provides that where property is transferred for less than an adequate and full consideration in money or money's worth, the amount by which the value of the property exceeds the value of the consideration is deemed a gift.

Section 2519(a) provides that any disposition of all or part of a qualifying income interest for life in any property to which the section applies is treated as a transfer of all interests in the property other than the qualifying income interest. Section 2519(b) provides that the section applies to any property if a deduction was allowed with respect to the transfer of such property to the donor under § 2056(b)(7).

The estate tax marital deduction provisions are intended to provide a special tax benefit that allows property to pass to the surviving spouse without the decedent's estate paying tax on its value. Tax is deferred on the transfer until the surviving spouse either dies or makes a lifetime disposition of the property. Under either circumstance, a transfer (estate or gift) tax is paid. United States v. Stapf, 375 U.S. 118, 128 (1963), 1964-1 (Part 1) C.B. 535, 537; Estate of Clayton v. Commissioner, 976 F.2d 1486, 1491 (5th Cir. 1992); Estate of Letts v.

Commissioner, 109 T.C. 290, (1997) ("It is a basic policy of the marital deduction that property that passes untaxed from a predeceasing spouse to a surviving spouse is included in the estate of the surviving spouse.")

The statutory scheme of the QTIP provisions is consistent with this congressional intent. Thus, a marital deduction is allowed under § 2056(b)(7) for property passing from a decedent to a QTIP trust in which the surviving spouse possesses a lifetime income interest. Sections 2519 and 2044 act to defer the taxable event on the marital deduction property only so long as the surviving spouse continues to hold the lifetime income interest.

Under § 2519, if a surviving spouse disposes of any part of the qualifying income interest, the spouse is treated as making a gift of the remainder interest in the underlying property (i.e., all interests in the property other than the income interest). Correspondingly, under § 2511, the disposition of the income interest by the spouse is treated as a gift, to the extent the income interest is transferred to another for less than adequate consideration.

The term "disposition," as used in § 2519, applies broadly to circumstances in which the surviving spouse's right to receive the income is relinquished or otherwise terminated, by whatever means. See H. Rep. No. 201, 97th Cong., 1st Sess. 161 (1981) that states:

The bill provides that property subject to a [QTIP election] will be subject to transfer taxes at the earlier of (1) the date on which the spouse disposes (either by gift, sale, or otherwise) of all or part of the qualifying income interest, or (2) upon the spouse's death.

A commutation, which is a proportionate division of trust property between the life beneficiary and remainderman based on the respective values of their interests is, in the context of a QTIP trust, a taxable disposition by the spouse of the qualifying income interest, resulting in a gift under § 2519 of the value of the remainder interest. The commutation of the spouse's income interest in the QTIP trust is essentially a sale of the income interest by the spouse to the trustee (or the remainderman) in exchange for an amount equal to the value of the income interest. Sales and commutations are expressly characterized as dispositions in the applicable legislative history and regulations. Section 25.2519-1(g), Example 2 (illustrating that the sale by the spouse of the spouse's income interest to the trust remaindermen is a disposition of the income interest); § 25.2519-1(f) providing that "[T]he sale of qualified terminable interest property, followed by the payment to the donee-spouse of a portion of the proceeds equal to the value of the donee-spouse's income interest, is considered a disposition of the qualifying income interest". See also, Estate of Novotny v. Commissioner, 93 T.C. 12 (1989), in which the surviving spouse and remainderman divided the sale proceeds of QTIP property

proportionately on the basis of the respective values of their interests; the court indicated that the commutation constituted a disposition by the spouse of the income interest for purposes of § 2519 and was thus subject to gift tax.

There is little distinction between the sale and commutation transactions treated as dispositions in the regulations and the transaction presented here, where S acquired the remainder interest. In both cases, after the transaction the spouse's income interest in the trust is terminated and the spouse receives outright ownership of property having a net value equal to the value of the spouse's income interest. Similarly, the remainderman receives ownership of property equal in value to the remainder interest. Thus, the transaction in the instant case essentially effectuates a commutation of S's income interest in the trust, a transaction that is a disposition of S's income interest under § 2519. Therefore, under § 2519, S is regarded as making a gift of x dollars, the value of the remainder interest in the QTIP Trust. Section 25.2519-1(f).

This conclusion that S has made a gift is also supported by an additional analysis. S acquired an asset (the remainder interest in the QTIP Trust) that is already subject to inclusion in S's transfer tax base under § 2044. In analogous situations, the courts have recognized that the receipt of an asset that does not effectively increase the value of the recipient's gross estate does not constitute adequate consideration for purposes of the gift and estate tax. See Commissioner v. Wemyss, 324 U.S.

303, 307 (1945), 1945 C.B. 416, ("The section taxing as gifts transfers that are not made for 'adequate and full [money] consideration' aims to reach those transfers which are withdrawn from the donor's estate.")

A companion case to Commissioner v. Wemyss, Merrill v. Fahs, 324 U.S. 308 (1945), 1945 C.B. 418, and the cases that preceded it, involved situations where A, an individual, transferred property to B, A's spouse (or future spouse), in exchange for B's relinquishment of marital rights in A's property. The Court held that B's relinquishment of the marital rights did not constitute adequate and full consideration for A's transfer because the assets subject to the marital rights were already includible in A's taxable estate. The property subject to dower and marital rights is clearly included in the gross estate of the property owner. Thus, to conclude that the relinquishment of dower and marital rights by the spouse of the property owner constituted adequate and full consideration for a transfer by the property owner for gift tax purposes would effectively subvert the legislative intent and statutory scheme of the gift tax provisions. Merrill v. Fahs, at 311-312. See also, Commissioner v. Bristol, 121 F.2d 129, 136 (1st Cir. 1941).

Likewise, in the present situation, property subject to the QTIP election was intended to be subject to either gift or estate tax. S's receipt of the remainder interest does not increase the value of S's taxable estate because that property is already subject to inclusion in S's taxable estate under § 2044. Rather,

S's issuance of the note results in a depletion of S's taxable estate that is not offset by S's receipt of the remainder interest. Thus, for estate and gift tax purposes, S's receipt of the remainder interest cannot constitute adequate and full consideration under § 2512 for the promissory note transferred by S to C. As was the case in Merrill v. Fahs, any other result would subvert the legislative intent and statutory scheme underlying § 2056(b)(7). Therefore, under § 2511, S has made a gift to C equal to the value of the promissory note S gave to C.

In addition, a gift tax would be imposed under the above alternative rationales even if S acquired only a portion of C's remainder interest; e.g., S acquired 60 percent of C's remainder interest. If, under applicable state law, such a transaction results in a partial termination of the trust, S would be treated as disposing of part of S's income interest in the trust, and the commutation analysis would apply. See, e.g., Restatement (Second) of Trusts § 340(2) (1959). See also, § 25.2519-1(g), Example 4, (illustrating the estate and gift tax consequences of the disposition of a portion of the spouse's income interest). If the trust does not terminate, S would nonetheless be treated as making a transfer under §§ 2511 and 2512 for less than adequate and full consideration to the extent of the value of the property or cash S transfers in exchange for the partial remainder interest.

Further, the conclusion of this revenue ruling would be the same if S transferred to C property or cash rather than the

promissory note. The economic effect of the transaction is identical, regardless whether S uses S's own funds to finance the transaction or gives a promissory note and discharges the note using some of the QTIP Trust assets received in the transaction. Thus, the result is the same for transfer tax purposes.

HOLDING

If a surviving spouse acquires the remainder interest in a trust subject to a QTIP election under § 2056(b)(7) in connection with the transfer by the surviving spouse of property or cash to the holder of the remainder interest, the surviving spouse makes a gift both under § 2519 and §§ 2511 and 2512. The amount of the gift is equal to the greater of (i) the value of the remainder interest (pursuant to § 2519), or (ii) the value of the property or cash transferred to the holder of the remainder interest (pursuant to §§ 2511 and 2512).

DRAFTING INFORMATION

The principal author of this revenue ruling is Deborah Ryan of the office of Assistant Chief Counsel (Passthroughs and Special Industries. For further information regarding this revenue ruling contact Ms. Ryan on (202) 622-3090 (not a toll-free call).