

Tax Results of Settling Trust Litigation Involving QTIP Trusts

Attempting to modify or terminate an established QTIP trust, either in settlement of litigation or otherwise, gives rise to numerous tax consequences, which can be a challenge, even for a seasoned tax practitioner.

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Qualified terminable interest property trusts (“QTIP” trusts) are trusts which, when funded, receive an estate or gift tax marital deduction under Section 2056(b)(7) or Section 2523(f). QTIP trusts are prime candidates for conflict between the surviving spouse and the remainder beneficiaries. These conflicts include disputes over (1) weighting of investments to produce income vs. principal (that is, whether the spouse or the remaindermen are unduly favored), (2) applying discretionary principal distribution standards, and (3) dealing with ambiguous trust provisions. When the children are the remaindermen and the spouse is not their natural mother, the likelihood of controversy is amplified.

Often, these disputes lead to trust litigation. At some point, the parties will entertain settling the dispute. Consideration will be given to modifying or terminating the QTIP trust, or changing bene-

ficiaries.¹ At times, estate and trust litigation may not directly involve a QTIP trust, but in the interest of separating parties to avoid future conflicts, there may be a willingness to modify or terminate a QTIP trust.

Unfortunately, tinkering with, modifying, or terminating a QTIP trust is rife with potentially adverse transfer tax and income tax consequences. Section 2519 alone, a key provision in this area, is not a paragon of clarity, and can be applied to many situations that are not apparent from its limited statutory language. Practitioners need to tread carefully in this area, so that the resolution of the disputed issues will not result in unintended tax consequences.

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This article addresses the principal federal tax effects of terminating, modifying, or transferring interests in QTIP trusts. While these issues typically arise in settling litigation, the tax principles discussed also apply to such events if they occur outside of trust controversies and as part of tax planning, or simply to implement the desires of one or more of the trust parties to modify or terminate a QTIP trust.

Direct disposition of income interest—by gift

The settlement of a trust dispute may involve a gratuitous transfer of a surviving spouse’s income interest in a QTIP trust to a third party. A disposition of all or part of a qualifying income interest in a QTIP trust triggers Section 2519.² One such triggering disposition is a gift of all or part of the income interest.³ Section 2519 treats the surviving spouse as making a taxable gift of the remainder interest

in the underlying trust property—that is, a taxable gift of all interests in trust property other than the income interest.⁴ Attempting to avoid Section 2519 through a non-qualified disclaimer by the surviving spouse will not be effective.⁵

Computing the amount of the taxable gift is a two-step process. Under the first step, the fair market value (“FMV”) of all trust property is determined as of the disposition date.⁶ This includes accumulated income. Under the second step, the value of the spouse’s income interest is computed, and deducted from the FMV of all trust property computed under the first step.⁷ The remaining amount is the taxable gift. Whether the gift is of all or only a part of the income interest, the same computation and taxable gift occur. The taxable gift is not eligible for exclusion, in whole or in part, as an annual exclusion gift.⁸ If only a portion of a trust is subject to a QTIP election, the taxable gift amount is prorated.⁹

Example. Joan is the surviving spouse of Fred, and has an income-only interest in a QTIP trust that was established for her when Fred died. Fred’s daughter, Nancy is the sole remainder beneficiary of the QTIP trust. The trust assets are \$1 million in securities. Using actuarial tables, based on Joan’s age, her life interest is worth \$400,000. Joan transfers half her income interest to Nancy, triggering a Section 2519 gift. Under the first step of the above computation, the FMV of trust property is determined—\$1 million. Under the second step, the value of Joan’s income interest (\$400,000) is deducted from the \$1 million, resulting in a Section 2519 gift of \$600,000.

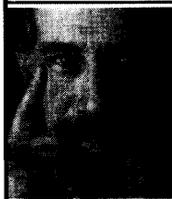
This taxable gift amount is subject to two potential adjustments. The first relates to Section 2207A(b), which provides a right of recovery to the surviving spouse for any gift taxes arising from a Section 2519 gift. If the surviving spouse is entitled to recover any gift tax on the taxable gift under Section 2207A(b),

the amount of the gift tax recoverable and the value of the remainder interest (and thus the amount of the taxable gift) are adjusted.¹⁰ The reason is that third parties are effectively paying part of the spouse’s tax by reason of the reimbursement disbursement to the spouse for the spouse’s gift tax. Such adjustment is calculated using the same interrelated computation that applies for other transfers under which a transferee assumes the gift tax liability.¹¹

The second potential adjustment relates to Section 2702. This section may apply when the effect of the transaction is a deemed transfer of the remainder interest to a family member of the surviving spouse, and the spouse retains a portion of the income interest.¹² If the surviving spouse retains a portion of the income interest (that is, less than all of the income interest is gifted) and such retention is valued at \$0 under Section 2702, the actual value of the retained income interest is added to the Section 2519 taxable gift amount.¹³



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¹ As a practical matter, it would appear that the terms of the QTIP trust (including spendthrift provisions and defined distribution terms) and state trust law would limit the ability of the parties to haphazardly modify or terminate the trust. Nevertheless, if all interested parties are involved or consent, such modifications, terminations, or distributions can usually be accommodated, at least as part of a court-approved settlement agreement.

² Section 2519(a), which reads “For purposes of this chapter and chapter 11, any disposition of all or part of a qualifying income interest for life in any property to which this section applies shall be treated as a transfer of all interests in such property other than the qualifying income interest.” A “qualifying income interest” is an income interest under a QTIP trust for which a marital deduction was taken under Section 2056(b)(7) or Section 2523(f). Section 2519(b). The conversion of a surviving spouse’s interest in a QTIP trust into other property that constitutes a qualifying income interest for life is not a disposition for purposes of Section 2519. Reg. 25.2519-1(f).

³ H. Rep’t No. 97-201, 97th Cong., 1st Sess. 161 (1981). Taxpayers may argue that a transfer by the surviving spouse of an interest in a QTIP trust as part of a bona fide settlement of litigation is not a gratuitous transfer and thus is not a taxable gift pursuant to the authority of Reg. 25.2512-8. However, in Field Service Advice (“FSA”) 199916025 (1/21/99), the IRS indicated that Section 2519 applies even if the transfer is not gratuitous. There, in

the situation of a surviving husband disposing of part of his income interest in settlement of litigation, the IRS advised “[a]lthough the inter vivos disposition of the qualifying income interest under section 2511 may be characterized as a transfer of property made in the ordinary course of business under Treas. Reg. § 25.2512-8, that does not affect the application of section 2519.” This interpretation is supported by the Code since Section 2519 is triggered by a “disposition” and not just a “gift,” and H. Rep’t No. 97-201 provides that the disposition can be by “gift, sale, or otherwise.” Such a disposition for consideration may incur gain or loss under Section 1001, as discussed in the section of this article on a disposition by sale.

⁴ The surviving spouse’s gift tax liability from a Section 2519 transfer is included for purposes of computing gift taxes on the surviving spouse’s subsequent inter vivos and testamentary transfers, and will consume the surviving spouse’s unified credit. Sections 2502, 2001(b)(1)(B), and 2001(b)(2). Gift tax paid by the surviving spouse within three years of death is likely included in the transferee spouse’s gross estate under Section 2035(b), even if the tax is recovered under Section 2207A(b). See Estate of Sachs, 88 TC 769 (1987). Some commentators believe that Section 2519 can also trigger a tax under the generation-skipping tax provisions of the Code absent a reverse QTIP election, even though Section 2519 refers only to the estate and gift tax chapters of the Code.

Other tax consequences beyond Section 2519 may apply. In determining all the tax effects of the gift, it is helpful to break the trust in two parts (or three parts, if the surviving spouse gifts only a part of the income interest), and examine each part separately. The first part to examine is the remainder interest. The second part is the income interest that is gifted away by the surviving spouse, and the third part is the income interest that is retained by the spouse if only a portion of the income interest is gifted away.

In regard to the first part, we have examined how Section 2519 creates a taxable gift of the remainder interest. Another tax incident relating to this part of the trust is that if the surviving spouse has a right of recovery of gift taxes under Section 2207A(b) relating to the deemed transfer of the remainder interest under Section 2519 *but chooses not to enforce it*, the spouse is treated as making a *separate* taxable gift of the amount of the taxes the spouse could have collected but did not.¹⁴ This taxable gift could occur in a calendar year later than the Section 2519 gift of the income

interest, since it generally does not occur until the right of recovery becomes unenforceable.¹⁵

In regard to the second part (i.e., the income interest that is gifted away), this gift also constitutes a *separate* gift under Section 2511, in addition to the gift arising under Section 2519.¹⁶ The amount of this separate gift is the value of the income interest transferred, less any consideration paid for it.¹⁷

Example. Continuing the example above, Joan transferred half of her income interest to Nancy. Therefore, Joan is also treated as having made an additional gift of \$200,000 (half of the \$400,000 value of the income interest under the QTIP trust).

Lastly, if there is a third part of the trust because the surviving spouse gave away a portion of the income interest but also retained a portion, the surviving spouse is considered to have a continuing interest in the trust due to the retained portion that will be included in the surviving spouse's gross estate at death under Section 2036. The spouse is treated under Section 2036 at death as "having transferred the entire trust corpus, including that portion of the trust corpus from which the retained income interest is payable."¹⁸ This Section 2036

inclusion will not include the entire value of the trust at death, but only a percentage of the value equal to the percentage of the income the surviving spouse retained.¹⁹ However, at the death of the surviving spouse, Section 2044 will not require any inclusion of the trust in the estate of the surviving spouse, since Section 2519 applied to the partial lifetime disposition.²⁰

Example. Again continuing the example, because Joan retained half of the income interest, half of the trust value at her death will be included in her gross estate under Section 2036.

If, under the trust instrument, a surviving spouse has a testamentary power of appointment over the remainder assets, even if the surviving spouse has no continuing interest in the trust, Section 2038 may still apply to tax the remainder assets at the surviving spouse's death.²¹

Disposition of income interest—by sale

Instead of the surviving spouse making a gratuitous transfer of all or part of the income interest of the QTIP trust, a sale of the interest for consideration may occur. A surviving spouse disposing of the income interest in a QTIP trust in

⁵ Ltr. Rul. 200022031, which also dealt with measuring the amount of the gift under Sections 2518 and 2519.

⁶ Reg. 25.2519-1(c)(1).

⁷ *Id.*

⁸ H. Rep't No. 97-201 (Pub. L. No. 97-34), pp. 161-162.

⁹ Regs. 25.2519-1(c)(2) and 25.2519-1(c)(3).

¹⁰ The amount of tax recoverable under Section 2207A(b) does *not* include the portion of the taxable gift under Section 2519 that is covered by the surviving spouse's remaining unified credit. H. Rep't No. 97-201, p. 162.

¹¹ Reg. 25.2519-1(c)(4).

¹² The Section 2702(d) limitation for partial transfers is likely inapplicable because the surviving spouse is deemed to transfer the entire remainder under Section 2519. A "member of the family" is defined in Section 2704(c)(2). Section 2702(e).

¹³ Reg. 25.2519-1(g), Example 4.

¹⁴ Reg. 25.2207A-1(b).

¹⁵ *Id.* Although if the transferor executes a written waiver of the right to recover before then, the gift is deemed to occur on the later of the date of the waiver, or the date of the tax payment by the surviving spouse.

¹⁶ Reg. 25.2519-1(a).

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exchange for the receipt of consideration is treated similarly under Section 2519 as a transfer by gift. Section 2519 again treats the spouse as if he or she made a taxable gift of the remainder interest.²² The Section 2519 taxable gift is computed in the same manner discussed above for a gift disposition. Also similar to a disposition of the income interest by gift, an additional taxable gift can occur if the surviving spouse has a right of recovery of gift taxes under Section 2207A(b) for the taxes relating to the Section 2519 transfer, but chooses not to enforce it.

Regarding the income interest that is sold, no separate taxable gift for transferring that interest occurs if the spouse receives consideration equal to the FMV of the income interest.²³ If the consideration is less than the value, a taxable gift for the difference occurs.

If only a portion of the income interest was sold so that the surviving spouse also retains a partial income interest, inclusion of that retained portion under Section 2036 should also apply at the surviving spouse's death.²⁴ Inclusion under Section 2044 will not occur at that time due to the prior application of Section 2519.²⁵

Under Section 1001, the selling surviving spouse realizes gain or loss on the disposition of the

income interest. However, because the surviving spouse acquired the life estate in the QTIP trust either by reason of the death of the first spouse to die or by gift from the other spouse, Section 1001(e) has an unwelcome surprise for the surviving spouse: *all* of the amount realized on the disposition will generate gain, without regard to basis allocable to the life interest. Section 1001(e) provides that in determining gain or loss from the sale or other disposition of a term interest in property, the portion of the adjusted basis of such interest which is determined under Section 1014 (relating to the basis of property acquired from a decedent), Section 1015 (relating to the basis of property acquired by gift or by a transfer in trust), or Section 1041 is disregarded.²⁶ An income interest in a trust is a "term interest" for this purpose.²⁷ However, if all the income interest and all remainder interests are simultaneously sold, Section 1001(e)(3) instead permits the allocation of basis to the income interest under the uniform basis rules.

Example. Assume under the preceding example that Joan sold half the income interest to Nancy for its FMV (\$200,000) instead of having transferred it as a gift. Under Section 2519, the same \$600,000 gift

occurs. But because Joan was paid for the income interest, no separate taxable gift of the income interest occurs. Nevertheless, Joan will recognize taxable gain equal to the full value of the one-half of the income interest sold, or \$200,000. The same inclusion of half the trust property at Joan's death occurs under Section 2036.

If the selling surviving spouse disposes of the income interest in settlement of litigation, and is deemed to have received valuable consideration for the disposition under the settlement, taxable gain or loss may result under the foregoing Section 1001 provisions.²⁸ That is, what first may appear to be a gratuitous transfer may in fact be for a valuable *quid pro quo* provided in the litigation settlement and thus be treated as a sale of the income interest.

Distributions of principal to spouse

Distributing trust principal is another method of reducing the size of a QTIP trust or eliminating it entirely, and so may be an avenue sought by litigating parties. This can often be accomplished without negative tax consequences; however, at other times Section 2519 or gift taxes can apply.

If the surviving spouse or a third party has a power to appoint principal of the trust to the spouse, the Reg-

¹⁷ In the context of the settlement of litigation, the transfer of the income interest may be considered to have been made for full consideration. In that circumstance, while Section 2519 will apply, a taxable gift of the income interest may not be applicable. See FSA 199916025 and the discussion at note 3 *supra*.

¹⁸ *Id.* However, there are arguments that the application of Section 2036 is unwarranted and that these Regulations are invalid. See Stephens, Maxfield, Lind, Calfee, and Smith, *Federal Estate and Gift Taxation* (Thomson Reuters/WG&L 2008), at ¶ 10.08[1][a], footnote 15 ["The Treasury's position should be challenged. When a QTIP election is made, the transferee spouse is not treated as the outright owner of the entire property...As a result, when the transferee spouse transfers a portion of the qualifying income interest triggering Section 2519, the transferee does not transfer the remaining income interest that

was originally transferred by the transferor spouse and, consequently, under the statutory language of Section 2036(a) did not 'transfer' or '[retain] for...life...the right to the income from...the property.'"]

¹⁹ Reg. 25.2519-1(g), Example 4. This retained interest also gives rise to an adjustment to the surviving spouse's adjusted taxable gifts under Section 2001(b)(1)(B).

²⁰ Section 2044(b)(2).

²¹ Stephens, Maxfield, Lind, Calfee, and Smith, *supra* note 18, at ¶ 10.08[1][a].

²² Reg. 25.2519-1(g), Example 2. See also Estate of Novotny, 93 TC 12 (1989), and Rev. Rul. 98-8, 1998-1 CB 541.

²³ Reg. 25.2519-1(g), Example (2).

²⁴ Reg. 25.2519-1(a).

²⁵ Section 2044(b)(2).

²⁶ See also Reg. 1.1014-5(a)(1), Reg. 1.1014-

5(b), Reg. 1.1014-5(c), Examples, and Reg. 1.1001-1(f)(1).

²⁷ Section 1001(e)(2)(C).

²⁸ Reg. 1.1001-1(a). Evans, 30 TC 798 (1958) (exchange of income interest in a trust for an annuity was a realization event). Ltr. Rul. 200231011 (relating to gain from a trust modification). However, see also *Silverstein*, 419 F.2d 999, 24 AFTR2d 69-5972 (CA-7, 1969) (exchange of trust interest for a right to specified annual payments from the remainderman of the trust was not a taxable disposition). It is unknown whether *Cottage Savings Association*, 499 U.S. 554, 67 AFTR2d 91-808 (1991) (properties exchanged are materially different, and thus give rise to a taxable disposition, if properties embody legal entitlements different in kind or extent or if the properties confer different rights and powers), if it had been decided before *Silverstein*, would have changed the result in *Silverstein*.

ulations under Section 2519 explicitly provide that such an appointment does not trigger Section 2519—even if the spouse subsequently disposes of the distributed property.²⁹ This presumably also covers discretionary or mandatory principal distributions required by the trust instrument, such as under health, education, maintenance, and support (“HEMS”) distribution standards.

What if this is taken a step further, and the surviving spouse and the remaindermen decide to *commute* the trust, so that the spouse receives trust principal equal to the actuarial value of her life income interest and the remaindermen receive principal equal to the value of their remainder interest? If analyzed from the perspective of the purpose of Section 2519 (which is to assure that the entire value of the QTIP trust enters into the transfer tax base of the surviving spouse in exchange for the previously granted marital deduction upon funding of the QTIP trust), Section 2519 should apply because only a portion of the QTIP trust is passing into the hands of the surviving spouse. Consistent with that reasoning, both case law and the IRS apply Section 2519 to the commutation of a QTIP trust.³⁰

The authorities hold that a commutation is the same as a sale by the surviving spouse of his or her income interest, which—as noted above—results in a taxable gift under Section 2519. However, commuting a QTIP trust should not

result in a taxable gift under Section 2511 as to a transfer of the surviving spouse’s income interest, since the surviving spouse is receiving full value for that interest.

Example. The facts are the same as above with regard to the QTIP trust. Joan and Nancy decide to resolve their dispute by commuting the trust; Joan will receive \$400,000 of the trust assets and Nancy will receive \$600,000, and the trust will terminate. The IRS will treat this as a \$600,000 taxable gift from Joan to Nancy under Section 2519.

Interestingly, in Ltr. Rul. 200723014, the IRS sanctioned a method of reducing the impact of Section 2519 on a *partial* commutation. In that letter ruling, an existing marital trust was divided under local law into two separate marital trusts—Trust A and Trust B. Trust B was then commuted. Under the ruling, Section 2519 applied only to the Trust B assets, and not the Trust A assets. Consequently, by first dividing the marital trust into two trusts, a partial disposition of the surviving spouse’s income interest gave rise to only a partial application of Section 2519.

The IRS reached a similar conclusion in Ltr. Rul. 199926019, in which a QTIP trust was divided into two trusts. There, the surviving spouse’s nonqualified disclaimer of her income interest in one of the two trusts was found not to create a Section 2519 taxable gift as to the other QTIP trust. Taxpayers should be cautious about relying on these rulings because Section 2519 applies to a transfer of only a portion of an income interest; a preliminary division into two trusts to avoid this result as to all trust assets would appear open to challenge, at least until more reliable authority than private letter rulings exists.

A commutation may also be characterized as a taxable sale by

the surviving spouse of his or her income interest.³¹ If so characterized, the surviving spouse will have gain under Section 1001 equal to the full amount received by him or her, since as noted earlier, no basis will be allocated to the life interest under the uniform basis rules and Section 1001(e).

Disposition of remainder interests—by gift

Another method of dealing with conflicts among beneficiaries is to remove one or more remaindermen from the trust. Gift transfers of remainder interests generally should not have any Section 2519 impact, since the surviving spouse is not disposing of his or her income interest. The remaindermen who make the gift will be making taxable gifts, to the extent of the value of the remainder interests and

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²⁹ Reg. 25.2519-1(e).

³⁰ Estate of Novotny, *supra* note 22; Rev. Rul. 98-8. When a commutation occurs, and the remainder beneficiary is a qualified charity, the deemed gift to the charity can qualify for the gift tax charitable deduction. Ltr. Rul. 200013015.

³¹ See Ltr. Rul. 200127023, in which the IRS treated the commutation of a charitable remainder trust as a taxable exchange by the individual lead interest holder, generating gain under Section 1001. There is a dearth of authority as to whether such taxable sale treatment is appropriate.

absent the receipt of adequate consideration.³² Actuarial computations can be problematic if the spouse's life interest allows withdrawal or distributions of principal to the spouse.³³

If the remaindermen gift their remainder interests to the surviving spouse, this should still not trigger a gift under Section 2519.³⁴ In this case, the surviving spouse has not made any disposition. Further, from a policy standpoint, the spouse is including all the QTIP assets into his or her transfer tax base under the doctrine of merger. The remaindermen, though, are making a taxable gift to the spouse, unless the transfer is for other consideration (in which case gain or loss may result).

In Ltr. Rul. 199908033, remaindermen making such a transfer argued that the value of the gift is \$0 because the transferred assets were already included in the spouse's transfer tax basis under Sections 2519 and 2044. The IRS rejected that argument, noting that the remainder interests had value to the remaindermen based on the willing buyer/willing seller standard, and thus, the transfer of those interests was subject to gift tax.

As a practical matter, a useful rule of thumb in determining when Section 2519 may apply is whether anyone other than the surviving spouse is effectively receiving an income interest in all or part of the trust or its assets—either by way of direct receipt of an income interest, or an outright distribution of trust assets. Applying this rule of thumb, transfers of income interests to others by gift or sale, commutations, or a purchase of a remainder interest by the surviving spouse trigger a Section 2519 gift. Transfers of remainder interests (other than by sale to the surviving spouse, as discussed below), and distributions of principal to the sur-

living spouse without a concomitant distribution of trust assets to remaindermen, do not trigger such a gift under the rule of thumb. The rule of thumb will also flush out potentially hidden Section 2519 gifts, such as when remaindermen receive a *quid pro quo* from the surviving spouse or the trust in exchange for authorizing a transfer from the trust or of their remainder interests to the surviving spouse, even though that *quid pro quo* may involve the receipt of assets or benefits not directly related to the QTIP trust.

Disposition of remainder interests—by sale

A sale of a remainder interest to anyone other than the surviving spouse should not have any impact under Section 2519, because the surviving spouse is not disposing of her income interest. The seller will recognize gain or loss on the sale under Section 1001, to the extent that the sale proceeds exceed his or her adjusted basis in the remainder.

The adjusted basis of the remainder equals the portion of the adjusted uniform basis assignable to the portion of the remainder being sold.³⁵ The uniform basis is the allocable portion of the unadjusted basis of the entire property determined immediately after the decedent's death or the time of the gift that funded the trust.³⁶ The *adjusted* uniform basis is the allocable portion of the entire property increased and decreased by the basis adjustments that occurred through the time of the sale.³⁷ The overall adjusted uniform basis is allocated to the remainder interest by multiplying the overall adjusted uniform basis by the appropriate actuarial factor based on the anticipated remaining term of the life interests of the QTIP trust.³⁸

If the purchaser of the remainder interest is the surviving spouse, the

IRS takes the position—under Rev. Rul. 98-8³⁹—that a Section 2519 gift (or Section 2511 and 2512 gift) is triggered.⁴⁰ The theory is that such a purchase is the economic equivalent of a taxable commutation of the QTIP trust; in the end, the remaindermen receive the actuarial value of the remainder, and the surviving spouse is left with only the actuarial value of his or her life interest. The spouse receives this value through the spouse's receipt of the total value of the trust received when it terminates by merger, less the spouse's outlay to purchase the remainder interest. The amount of the taxable gift is the greater of (1) the value of the remainder interest gift under Section 2519, and (2) the value of the property or cash transferred to the holder of the remainder interest (under Sections 2511 and 2512). This result occurs whether the purchase is for cash or for a promissory note.⁴¹

In Rev. Rul. 98-8, the IRS anticipated an argument that no taxable gift occurs under Section 2519 on the purchase because the surviving spouse purchases the remainder interest for adequate and full consideration. The IRS rejected this argument, noting that the spouse was acquiring an asset that was already in the spouse's transfer tax base per Section 2044. The IRS also stated that in analogous situations, courts have recognized that the

³² Even if the recipient is the surviving spouse, as discussed above. Ltr. Rul. 199908033.

³³ Reg. 1.7520-3(b)(1)(ii); Reg. 20.7520-3(b)(2)(v), Examples 4 and 5.

³⁴ If all the remainder interests are paid to the surviving spouse, under the doctrine of merger the trust should terminate in favor of the surviving spouse.

³⁵ Reg. 1.1014-5(a)(1).

³⁶ *Id.*

³⁷ *Id.*

³⁸ Reg. 1.1014-5(a)(3). The factors are published in Regs. 20.2031-7 and 20.2031-7A for property received from decedents dying before 5/1/99.

³⁹ 1998-1 CB 541.

⁴⁰ Rev. Rul. 98-8; Ltr. Rul. 199936036.

⁴¹ *Id.*

receipt of an asset that does not effectively increase the value of the recipient's gross estate (here, the remainder interest) does not constitute adequate consideration for purposes of the gift and estate tax.⁴²

If only a portion of the remainder interests are purchased by the surviving spouse, it would appear that the commutation analysis would not apply since the trust would not terminate by operation of merger. Nonetheless, Rev. Rul. 98-8 states that a gift tax would still be imposed if under applicable state law such a partial purchase results in a partial termination of the trust. While the Revenue Ruling is unclear, in the circumstance of a partial termination of the trust a full taxable gift under Section 2519 likely applies, because only a partial transfer of an income interest by a spouse triggers a full taxable gift under Section 2519. If a partial termination does not occur under state law, the amount paid to the remaindermen should still constitute a gift under Sections 2511 and 2512.

In the context of settlement of litigation, perhaps a third party other than the surviving spouse may be located to buy out the remaindermen. In such circumstances, care must be taken that such transactions are bona fide, and that the purchaser is not acting as nominee or alter ego for the spouse or otherwise is funded by the spouse or transfers the economic benefit of the purchased remainder back to the spouse; otherwise, the IRS may be able to recast the purchase as a purchase by the surviving spouse.

⁴² The validity of the Ruling has not gone unchallenged by commentators. See Lipoff, "Purchase of QTIP Remainder—Revisiting Purchases of Remainder Interests in QTIP Trusts," 27 ETPL 114 (Mar./Apr. 2000).

⁴³ Regs. 20.2056(b)-5(f)(1), 20.2056(b)-7(d)(1), 25.2523(e)-1(f)(1), 25.2523(f)-1(c), and 1.643(b)-1.

⁴⁴ Ltr. Ruls. 200752026, 200752027, and 200752028.

Principal distributions to remaindermen

Technically, under the QTIP rules, a QTIP trust cannot pay out principal to a remainderman during the lifetime of the surviving spouse. Therefore, such a payment should not usually arise. Nonetheless, in the context of settling trust litigation, or upon application to a court or through the use of state statutes for amending trusts, a modification of a trust to allow or accommodate such a transfer may occur long after the QTIP trust was set up and a marital deduction permitted. The question arises whether such a distribution of principal to a remainderman will trigger Section 2519.

The policy of Section 2519 suggests that such a distribution will trigger a taxable gift under Section 2519. The purpose of Section 2519 is to backstop Section 2044 by assuring that transfer taxes result on the QTIP trust assets if the assets are transferred in a manner that reduces the transfer tax base of the surviving spouse. Such a distribution to remaindermen would do just that.

The IRS interprets the word "disposition" under Section 2519 broadly. In Rev. Rul. 98-8, the IRS concluded that such term "applies broadly to circumstances in which the surviving spouse's right to receive the income is relinquished or otherwise terminated, by whatever means." A transfer of principal of the QTIP trust to the remaindermen terminates the surviving spouse's right to receive income from that principal. Consequently, a strong argument can be made that Section 2519 will apply to a principal distribution to a remainderman.

Conversion of QTIP income interest to unitrust interest

Conversion of a traditional income (or income and principal) interest of a surviving spouse to a unitrust

interest may resolve disputes between the spouse and other beneficiaries relating to the investment of trust assets and/or discretionary distributions to the spouse. The IRS Regulations now provide that a unitrust interest of between 3% and 5% that is treated as the equivalent of income under applicable state law can meet the requirements of Section 2056(b)(7)(B)(ii)(I) that all the income of the trust be distributed to the spouse.⁴³

Accordingly, converting a traditional income trust to a unitrust in states that meet the IRS requirements likely should not be troublesome for the IRS. This is especially so in light of recent private letter rulings that conclude that a conversion of a regular income trust to a unitrust does not trigger Section 1001 gain or loss to any of the beneficiaries, will not be considered to shift any beneficial interest in the trust, and does not cause a trust to lose its status as exempt from generation-skipping tax.⁴⁴ Hence, such a conversion should likely not cause a taxable gift under Section 2519. However, because there is no direct authority on this issue, a private letter ruling would be helpful to confirm this treatment.

Conclusion

Attempting to modify, terminate, or deal with an established QTIP trust, either in settlement of litigation or otherwise, gives rise to numerous tax consequences, which can be a challenge, even for a seasoned tax practitioner. Nonetheless, with knowledge of the potential pitfalls, a plan of action that makes provision for the tax consequences or that can navigate around them can usually be developed. (Exhibit 1 shows the consequences of QTIP trust modifications.) ■

EXHIBIT 1
Summary of Principal Tax Consequences of QTIP Trust Modifications

| TYPE OF DISPOSITION | \$2519 Taxable Gift | \$2511 / \$2512 Taxable Gifts | Gain / Loss | Death of Surviving Spouse | Misc. |
|---|---|---|---|--|---|
| Surviving spouse ("SS") gifts away income interest | <p>Deemed gift by spouse of and equal to value of entire remainder interest.</p> <p>Compute by valuing entire trust, less value of entire income interest.</p> <p>Interrelated computation if spouse entitled to recover gift tax under §2207A(b).</p> <p>Potential §2702 adjustment.</p> <p>No annual exclusion.</p> | <p>Taxable gift by SS of fair market value of portion of income interest gifted away.</p> <p>If SS has §2207A(b) right of recovery but does not enforce it, the forgiven taxes are a taxable gift.</p> | | <p>No §2044 gross estate inclusion at death of SS.</p> | <p>§2036 inclusion of portion of trust at SS's death, if SS retains a portion of the income interest.</p> |
| SS sells entire income interest (including sales to remaindermen) | <p>Deemed gift by spouse of and equal to value of entire remainder interest.</p> <p>Compute by valuing entire trust, less value of entire income interest.</p> <p>Interrelated computation if spouse entitled to recover gift tax under §2207A(b).</p> <p>No annual exclusion.</p> | <p>Taxable gift by SS of fair market value of interest transferred, less amount that SS is paid – no gift if paid fair market value.</p> <p>If SS has §2207A(b) right of recovery but does not enforce it, the forgiven taxes are a taxable gift.</p> | <p>§1001 gain to SS – no basis allowed to SS on gain computation.</p> | <p>No §2044 gross estate inclusion at death of SS.</p> | <p>§2036 inclusion of portion of trust at SS's death, if SS retains a portion of the income interest.</p> |

EXHIBIT 1, cont'd
Summary of Principal Tax Consequences of QTIP Trust Modifications, cont'd

| TYPE OF DISPOSITION | §2519 Taxable Gift | §2511 / §2512 Taxable Gifts | Gain / Loss | Death of Surviving Spouse | Misc. |
|--|--|---|---|---|--|
| Distribution to SS via Complete Commutation of Trust | Same as sale by SS of entire income interest. | Presumably no taxable gift since SS deemed to have sold income interest for full value. If SS has §2207A(b) right of recovery but does not enforce it, the forgiven taxes are a taxable gift. | May give rise to §1001 gain to SS – no basis allowed to SS on gain computation. | No §2044 gross estate inclusion at death of SS. | |
| Gift of Remainder Interest | | Taxable gift by remainderman. | | | |
| Sale of Remainder Interest | If SS is purchaser, §2519 applies as if a sale by SS of income interest. | Taxable gift by remaindermen to extent sold for less than fair market value. Possible gift by spouse if spouse purchases partial remainder interest and not a partial termination of the trust under local law. | §1001 gain or loss to seller. | | Uncertain application of §2036 at death of SS if partial purchase by SS. |
| Distribution of Principal to Remainderman | Presumably triggers §2519. | | | | §2036 may apply at death of SS. |