199903031

INTERNAL REVENUE SERVICE
TECHNICAL ADVICE MEMORANDUM

Index No.: 2056.07-03
Control No.: TAM-106475-98

SEP 30 1998

Taxpayer's Name:
Taxpayer's ID Number:
Taxpayer's Address:

Year of Death:

Date of Conference:
District Director:

LEGEND:

A =
B =
C =
State =
Trust =
date 1 =
date 2 =
date 3 =
date 4 =
date 5 =
date 6 =

Issue:

Does B have a qualifying income interest for life, within the meaning of § 2056()(7)(B)(ii) of the Code, in any portion of the Family Trust created pursuant to the terms of the Trust executed by A?

Conclusion:

B does not have a qualifying income interest for life in any portion of the Family Trust because, pursuant to the terms of the Trust executed by A, the trustees of the Family Trust had the power to appoint the principal of the Family Trust to someone other than B during B's life.

Facts:

On date 1, A executed his will and created a revocable living trust (Trust). At that time, A was married and had two adult children from a prior marriage. A's daughter was 53 years of age, and A's son was 55 years of age. A's son was married and the father of five children. A acknowledged his love and affection for his son in the Trust document and stated he was specifically not making any provisions for his son because, with A's assistance over the years, his son had become a very successful businessman and had accumulated substantial assets.

A died approximately 3 years later, on date 2. He was survived by his wife, B, his daughter, C, his son, and his five grandchildren. Under the terms of A's will, upon A's death, all of A's property was to be distributed to the Trust, and B and C were to become the cotrustees of the Trust.

Article Six, Section 6(c), of the Trust provides, "My Trustee, in its sole and absolute discretion, may elect to have trust property qualify for the federal estate tax marital deduction as qualified terminable interest property under the appropriate provisions of the Internal Revenue Code and its regulations."

Article Eight of the Trust directs the trustee, at A's death, to divide the Trust property into two separate trusts: a Marital Trust and a Family Trust. The Marital Trust is to consist of a dollar amount equal to the maximum dollar amount which B would be entitled to receive pursuant to State statute (B's elective share) if B elected against A's will. The Family Trust is to consist of the balance of the trust property.

Article Nine governs the Marital Trust. It provides that the Marital Trust is to be divided into two shares: Marital Share One and Marital Share Two. Marital Share Two was never established or funded and is not relevant to the issue in this case. Therefore, Marital Share One will hereafter be referred to as the Marital Trust.

Article Nine further provides that the trustees are to apply for B's benefit, at least monthly during B's lifetime, all of the net income from the Marital Trust. The trustees are to pay to or apply for B's benefit such amounts from the principal of the Marital Trust as B may at any time request in writing. No limitation is to be placed on B as to either the amount or reason for such invasion of principal. The trustees are also authorized to distribute, in their sole discretion, as much of the principal as necessary or advisable for B's education, health, maintenance and support. In making such distributions, the trustees are to take into consideration, to the extent that the trustees deem

advisable, any income or resources of B which are outside of the trust and are known to the trustees.

Section 2(d) of Article Nine provides B with an unlimited and unrestricted general power to appoint the entire principal and any accrued and undistributed income of the Marital Trust as it exists at B's death. In default of B's exercise of the power of appointment, the principal and any accrued and undistributed income is to be distributed to the Common Trust (described below).

Article Ten governs the Family Trust. Section 1 of Article Ten provides that the trustee "shall distribute to or for the benefit of my spouse and my named beneficiaries as much of the net income of the Family Trust as follows:

> My Trustee shall distribute fifty (50%) percent of the net income to my wife, [B] if she survives me, in monthly or other convenient installments. In the event that [B] predeceases me, then her share shall be paid over to my daughter [C].
>
> My Trustee shall distribute fifty (50%) percent of the net income to my daughter, [C], in monthly or other convenient installments, if she survives me. In the event that [C] predeceases me, then her share shall be distributed to my Common Trust [described below].

Section 1(a) of Article Ten provides:

> Any net income of the Family Trust which is not distributed by my Trustee shall be accumulated and added to the principal of the Family Trust. It is however, my intention that all income of the Family Trust be distributed to the beneficiaries hereinbefore named.

Section 1(b) of Article Ten provides, "In making discretionary distributions of principal to my spouse, my Trustee shall make all distributions of principal from the Marital Trust."

Section 1(c) of Article Ten provides, "Discretionary distributions under the Family Trust shall be made only to my named beneficiaries." The only named beneficiaries in Article Ten are B and C.

Section 2 of Article Ten provides, "My Trustee shall be mindful that my primary concern and objective is to provide for the education, health, maintenance, and support of my spouse and my named beneficiaries, and that the preservation of principal is

important in the accomplishment of these objectives."

Section 3 of Article Ten provides that, "The Family Trust shall terminate upon the death of the last survivor of the beneficiaries named above. The remainder of the Family Trust, including any accrued and undistributed net income, shall be administered [as the Common Trust]."

Article Eleven governs the Common Trust. The Common Trust was to be created at the termination of the Family Trust, that is, upon the death of the survivor of B and C, and was to continue until A's youngest living grandchild reached the age of 21, or received a degree from an accredited college or university prior to reaching age 21, at which time the property of the Common Trust was to be distributed outright to A's grandchildren and the living descendants of deceased grandchildren. At the present time, the beneficiaries of the Family Trust (B and C) are still alive, and A's youngest living grandchild has reached the age of 21. Therefore, as a practical matter, the Common Trust will never come into existence.

Article Thirteen provides, "If at any time there is no person, corporation, or other entity entitled to receive all or any part of my trust property, then... [a]ll of the trust property shall be distributed to those persons who would be my heirs if I had died intestate owning such property."

A's will was admitted to probate by the county surrogates court of State on date 3, nearly 9 months after A's date of death. Approximately 4 months later, on date 4, B and C, as co-trustees of the Trust, filed a "Petition for the Reformation and Construction of a Living Trust" (Petition) in the surrogates court.

The petitioners requested the court to reform the Family Trust into two separate trusts, Family Trust I and Family Trust II "in order [t]o resolve any doubt as to whether [B's] share of the Family Trust would qualify for the marital deduction ... and to direct that language be set forth in the separate trust for [B] authorizing her as Executrix to make an election under Section 2056(b) of the Internal Revenue Code to qualify the said separate trust for the federal estate tax marital deduction."

In Section 1 of Article Ten of his Trust, A provided that the income of the Family Trust was to be distributed 50 percent to B and 50 percent to C. In Section 3 of Article Ten, A provided that upon the death of B and C, the principal of the Family Trust was to be used to fund the Common Trust for the benefit of A's grandchildren (or to be distributed to them outright if the youngest living grandchild had reached the age of 21).

Article Ten contained no provisions regarding the distribution or accumulation of 50 percent of the income during the interval between the death of the first to die of B or C and the death of the second to die. The petitioners did not request the court to determine what should be done with this 50 percent of the income during this period. Rather, they requested the court to construe the terms of the Family Trust as meaning that the principal of Family Trust I was to be held for the benefit of B and the principal of Family Trust II was to be held for the benefit of C. The Petition requested the court to construe Article Ten (rewritten as part of Article Eight) as meaning that both the income and principal of Family Trust I (B's share) would pass to C if B predeceased C, and that both the income and principal of Family Trust II (C's share) would pass to B if C predeceased B.

On date 5, approximately 2 months after the Petition was filed, the remainder beneficiaries (A's grandchildren) of the Family Trust filed a "Verified Answer with Objections and Requests for Alternative Relief" (Answer) with the court. The document denies some matters alleged in the petition filed by B and C but states that the respondents, "admit that an appropriate reformation of the [Family] Trust would be permissible in order to obtain the advantage of an additional marital deduction; do not object to Court approval of an otherwise appropriate reformation of the [Family] Trust to obtain an additional estate tax marital deduction...." The Answer affirmatively requests that a decree be granted requiring that in the event the Family Trust is divided so as to have one share qualify for the QTIP election, that the decree provide that there shall be no principal distributions from the QTIP trust during the life of B.

Shortly after the Answer was filed, the petitioners and the remainder beneficiaries entered into a stipulation (Stipulation). The parties stipulated that a decree be issued by the court that incorporated substantially the changes requested in the Petition and that added the following language to the reformed terms of the Family Trust I: "There shall be no principal distributions from this trust."

On date 6, approximately 3 months after the Petition was filed, the court issued its decree (Decree) in response to the Petition and as a result of the Stipulation. The Decree ordered that the Trust be construed to read that the Family Trust is to be subdivided into two separate and equal trusts: Family Trust I for the benefit of B and Family Trust II for the benefit of C. The net income of Family Trust I is to be paid to B at least monthly, during B's life. Upon the death of B, the principal of Family Trust I is to be distributed to Family Trust II for the benefit of C, if living, or if deceased, to the Common Trust.

The Decree states that the executrix of A's estate is to determine in her absolute discretion whether to elect under § 2056(b) to qualify Family Trust I for the federal estate tax marital deduction. The Decree also states that there are to be no distributions of principal from Family Trust I.

The Decree also provides that Family Trust II is to be held for the exclusive benefit of C. The trustee is to pay to C or to apply for her benefit, at least monthly during C's lifetime, all of the net income. In the event that C predeceases B, Family Trust II will continue for the benefit of B, paying all net income to B at least quarter-annually. Upon the death of the survivor of B and C, the principal of Family Trusts I and II will pass to the Common Trust. The Decree does not state, nor did the parties request, that there are to be no distributions of principal from Family Trust II.

On A's federal estate tax return, a qualified terminable interest property (QTIP) election was made and a marital deduction was claimed with respect to 50 percent of the Family Trust.

Law and Analysis:

Section 2001(a) imposes a tax on the transfer of the taxable estate of every decedent who is a citizen or resident of the United States.

Section 2056(a) provides that, for purposes of the tax imposed by § 2001, the value of the taxable estate is to be 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.

Section 2056(b)(1) provides the general rule that no deduction shall be allowed for an interest passing to the surviving spouse if, on the lapse of time, on the occurrence of an event or contingency, or on the failure of an event or contingency to occur, the interest will terminate or fail.

Section 2056(b)(7)(A) provides that, in the case of qualified terminable interest property (QTIP), the property shall be treated as passing to the surviving spouse for purposes of § 2056(a) and no part of the property shall be treated as passing to any person other than the surviving spouse.

Section 2056(b)(7)(B)(i) defines "qualified terminable interest property" as property: (1) which passes from the decedent, (2) in which the surviving spouse has a qualifying income interest for life, and (3) to which an election under § 2056(b)(7)(B)(v) applies.

Section 2056(b)(7)(B)(ii) provides that the surviving spouse will be considered to have a qualifying income interest for life if the surviving spouse is entitled to all of the income from the property payable annually or at more frequent intervals, and no person has a power to appoint any part of the property to any person other than the surviving spouse during the surviving spouse's lifetime.

Sections 2056(b)(7)(B)(iii) and (iv) provide that the term "property" includes an interest in property, and a specific portion of property shall be treated as separate property.

Section 2056(b)(7)(B)(v) provides that an election under section 2056(b)(7) with respect to any property shall be made by the executor on the return of tax imposed by section 2001. Such an election, once made, shall be irrevocable.

Section 20.2056(b)-7(b)(2) of the Estate Tax Regulations provides that the QTIP election may relate to all or any part of property that meets the requirements of section 2056(b)(7)(B)(i), and that a trust may be divided into separate trusts to reflect a partial election that has been made, or is to be made, if authorized under the governing instrument or otherwise permissible under local law.

Section 20.2056(c)-2(d) of the regulations provides that if, as a result of a controversy involving the decedent's will, or involving any bequest or devise thereunder, a property interest is assigned or surrendered to the surviving spouse, the interest so acquired will be regarded as having "passed from the decedent to his surviving spouse" only if the assignment or surrender was a bona fide recognition of enforceable rights of the surviving spouse in the decedent's estate. Such a bona fide recognition will be presumed where the assignment or surrender was pursuant to a decision of a local court upon the merits in an adversary proceeding following a genuine and active contest. However, such a decree will be accepted only to the extent that the court passed upon the facts upon which deductibility of the property interests depends. If the assignment or surrender was pursuant to a decree rendered by consent, or pursuant to an agreement not to contest the will or not to probate the will, it will not necessarily be accepted as a bona fide evaluation of the rights of the spouse.

Section 7-1.13 of State trust law provides that, notwithstanding any contrary provision of law, unless expressly prohibited by the terms of the disposing instrument: (1) the trustee of an express trust is authorized without prior court approval or the consent of the persons interested to establish two or more separate trusts in order to segregate for any of the

following purposes: *** (B) property held in trust with respect to which a martial deduction under section 2056 or 2523 of the United States Internal Revenue Code would be available, by election or otherwise, from property held in trust for persons other than the spouse or surviving spouse, so that one or more of such separate trusts qualify for the deduction under said sections.

It is our opinion that A's testamentary dispositions with respect to the Family Trust are unclear or ambiguous in three respects. First, because the provisions of Section 1 and Section 1(a) of Article Ten are contradictory, there is a question as to whether all income is to be distributed annually to B and C in equal shares, or whether income can be accumulated. The Petition did not request the court to resolve this issue, but instead informed the court that the Trust terms provided for the distribution of all income equally to B and C. This question is also not addressed in the Answer to the Petition.

Regardless of the contradictory provisions, Section 1(a) of Article Ten contains an express intent that all income be distributed, 50 percent each to B and C. State law follows the law of most states in that its courts have the inherent power to resolve facial ambiguities or internal inconsistencies in dispositive instruments by searching within the document for the intent of the testator as expressed in the instrument. This intent is determined from a reading of the instrument as a whole and in view of the facts and circumstances under which its provisions were framed. We believe that Section 1(a) clearly expresses A's intent that all of the income of the Family Trust was to be distributed equally to B and C. Therefore, if the Family Trust is divided into two separate trusts, B would be entitled to all of the income of her separate trust, which is one of the requirements for qualified terminable interest property under section 2056(b)(7)(B)(ii).

The second uncertainty regarding the Family Trust stems from Section 1 of Article Ten, which makes no provision for B's 50 percent of the income if B dies survived by C or for C's 50 percent of the income if C dies survived by B. As stated above, the Petition did not request the court to clarify this uncertainty, but, rather, requested the court to construe Section 1 of Article Ten as meaning that both the income and principal of a one-half share of the Trust was intended by A to be held for the benefit of B and both the income and principal of the other one-half share was intended by A to be held for the benefit of C.

The issue regarding the payment of 50 percent of the income of the Family Trust during the interval between the deaths of B and C is not relevant to the question of whether B has a qualifying income interest for life in 50 percent of the Family

Trust. Whether the surviving spouse's income interest terminates at her death, with the remainder passing to the remaindermen at that time, or whether there is a second income interest following the surviving spouse's death, makes no difference with respect to the requirements for qualified terminable interest property. By the same token, if B were to receive C's 50 percent of the income of the Family Trust at C's death, this would have no relevance to whether or not B has a qualifying income interest in a one-half share of the Family Trust.

The third uncertainty encountered in A's Trust is whether the principal of the Family Trust may be invaded during B's life for the benefit of anyone other than B. Under section 2056(b)(7)(B)(ii), the surviving spouse does not have a qualifying income interest in property which passes from the decedent if any part of the property can be appointed to anyone other than the surviving spouse during the surviving spouse's lifetime. The determination of whether or not a property interest which passes from the decedent to the surviving spouse qualifies for the marital deduction must be made as of the date of the decedent's death. Jackson v. United States, 376 U.S. 503, 508 (1964).

None of the parties to the judicial proceeding requested the court to construe the provisions of the Trust -- as executed by A -- to determine whether the trustees could distribute principal from the Family Trust to anyone other than B during her lifetime, and the court did not rule specifically on this issue.

It is our opinion that the Trust instrument executed by A shows that A intended that the principal of the Family Trust could be invaded for the benefit of C, during the life of B, in the discretion of the trustees. Our conclusion is based on the following rationale. First, all agree that distribution of income to B and C during their lives is mandatory, not discretionary. (If this were not the case, B would not be entitled to all of the income from 50 percent of the Trust which is a requirement for a qualifying income interest under section 2056(b)(7)(B)(ii)). Second, since income distributions are mandatory, "discretionary distributions" in Section 1 of Article Ten must apply to principal distributions. Third, the only permissible distributees of the "discretionary distributions" are the "named beneficiaries" of the Family Trust. Fourth, the only "named beneficiaries" of the Family Trust in Article Ten are B and C. Fifth, A clearly provided in Section 1(b) of Article Ten that discretionary distributions of principal to B were to be made only from the Marital Trust. Therefore, A must have intended that discretionary distributions of principal from the Family Trust could be made to C while B was still living.

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Our conclusion is supported by the Decree which was issued in response to the Petition, Answer, and Stipulation. The Decree provides that distributions of principal may not be made from Family Trust I, which is the one-half share of the original Family Trust segregated as a separate trust for the benefit of B by that same Decree. However, the Decree does not so provide with respect to the principal of Family Trust II, which is the separate trust created for the benefit of C.

Our conclusion is also supported by a reading of the entire Trust instrument as executed by A in view of the facts and circumstances that existed when executed by A. A expressly did not provide in the Trust for his son because he thought his son was more than capable of caring for himself and his family financially. A evidently did not believe the same was true for his daughter, C. He expressly stated in Section 2 of Article Ten that his "primary concern and objective is to provide for the education, health, maintenance, and support of my spouse and my named beneficiaries, and that the preservation of principal is important in the accomplishment of these objectives." In furtherance of his objective with respect to his spouse, A provided her for her lifetime with all of the income from the Marital Trust, which consisted of that amount of his estate to which she would have been entitled had she elected against A's will under State law, and 50 percent of the income from the Family Trust. She was also entitled to the principal of the Marital Trust in any amount, at any time, for whatever reason she desired. A included terms within the provisions of the Marital Trust which specifically qualify that trust for the marital deduction.

On the contrary, A did not intend that the Family Trust or any part of it qualify for the marital deduction. A's "primary concern and objective" in creating the Family Trust was to provide for its named beneficiaries, B and C, for their lives and, presumably, to pass the principal, after their deaths, to his grandchildren. For this latter reason, C was not given the unfettered right to invade the principal of the Family Trust. While B and C were to share the income from this trust, B also had at her disposal all of the income and assets of the Marital Trust. A could not be assured that 50 percent of the income of the Family Trust would be sufficient to provide for C's education, health, maintenance and support for her life and, therefore, he provided for discretionary distributions of principal to her for these purposes. It is our opinion that, if the Family Trust had not been reformed into two separate trusts, the local court would hold that under the terms of the trust as executed by A, C would be entitled to the principal of the trust to the extent that it was necessary for her education, health, maintenance and support.

In Commissioner of Internal Revenue v. Bosch, 387 U.S. 456 (1967), the issue before the Supreme Court was the effect to be given to a state court's determination regarding the validity of a surviving spouse's release of a general power of appointment (that was relevant in determining a trust's qualification for the estate tax marital deduction). After reviewing the legislative history of the marital deduction statute, the Court found that Congress did not intend state court actions to have a determinative effect on federal tax questions. The Court concluded that "proper regard, not finality, should be given to interpretations of the will" by state courts and then only by a court in a bona fide adversary proceeding." See S. Rep. No. 1013, 80th Cong. 2d. Sess. 4 (1948).

The Supreme Court held in Bosch that where the federal estate tax liability turns upon the character of a property interest held and transferred under state law, federal authorities are bound only by a determination made of such property interest by the highest court of the state. If there is no decision by the state's highest court then federal authorities must apply what they find to be the state law after giving "proper regard" to relevant rulings of other courts of the state.

Of the three ambiguous provisions of the Family Trust discussed above, two were relevant to the question of whether B had a qualifying income interest for life in the property comprising the Family Trust: one, whether, under the terms of the trust, B was entitled to all of the income from the property or a specific portion of the property and, two, whether, under the terms of the trust, anyone had a power to appoint any part of the property to anyone other than B during B's life. Neither the Petition nor the Answer directed the court to these questions, and there is no indication in the Decree that the court specifically interpreted A's intent with respect to them. In this regard, we do not believe that the Decree can be characterized as "a decision of a local court upon the merits in an adversary proceeding following a genuine and active contest within the meaning of § 20.2056(c)-2(d) of the Estate Tax Regulations. While the judicial proceeding may have been the appropriate means of clarifying the uncertainties of the trust provisions, we believe the intent of the proceeding, based upon the Petition, Answer, and Stipulation, was to effect a federal estate tax liability beneficial to all the parties, as was the case in Bosch.

Moreover, the authority granted to the trustee to separate a trust into two trusts under section 7-1.13 of State's trust law can only apply to trusts which, by their terms, satisfy the requirements for the federal estate tax marital deduction. If the trust satisfies these requirements and the marital deduction is claimed for only a portion of the trust, the trust may then be

divided into separate trusts, those for which the deduction is claimed and those for which the deduction is not claimed. This interpretation of State law section 7-1.13 is in accord with § 20.2056(b)-7(b)(2) of the Estate Tax Regulations which provides that the QTIP election may relate to all or any part of property that meets the requirements of section 2056(b)(7)(B)(i), and that a trust may be divided into separate trusts to reflect a partial election that has been made, or is to be made, if such division is permissible under local law.

In the present case, we have found that under the terms of the Family Trust as executed by A, discretionary distributions of principal were authorized to be made to C during the life of B. Therefore, at the date of A's death, B did not have a qualifying income interest for life in any portion of the Family Trust under section 2056(b)(7)(B)(ii). The subsequent construction and reformation of the trust's terms, and the division of the trust into two separate trusts, can not and did not convert B's terminable income interest for life in the Family Trust into a qualifying income interest for life in a one-half portion of the Family Trust.

Caveat:

A copy of this technical advice memorandum is to be given to the taxpayer. Section 6110(j)(3) provides that it may not be used or cited as precedent.

-END-