Anenberg v. Commissioner, 162 T.C. No. 9 (May 20, 2024)

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Important Case for Planning With Existing QTIP Trusts: Unanimous Reviewed Tax Court Opinion Rejecting A Section 2519 Argument the IRS Has Been Making With Increasing Frequency

Steve R. Akers

Senior Fiduciary Counsel
Bessemer Trust
300 Crescent Court
Suite 800
Dallas, TX 75201
214-981-9407
akers@bessemer.com
www.bessemer.com

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1. Synopsis

The Tax Court, in a unanimous reviewed opinion, rejected an attack on Qualified Terminable Interest Property (QTIP) trust planning that the IRS has been making with increasing intensity in recent years. Assets in QTIP trusts (including their future appreciation) will eventually be subject to transfer tax. One planning approach is to move trust assets into the hands of the spouse-beneficiary by distributions to the spouse or by the exercise of a power of appointment in favor of the spouse (see Reg. §25.2519-1(e)), who can then engage in traditional transfer planning alternatives. If the distribution standards are not broad enough to allow direct distributions of assets to the spouse by the trustee or if the trust does not give someone the power to appoint assets to the spouse, an approach that has been used by some planners is to obtain a judicial termination of the trust, resulting in all the trust assets being distributed to the spouse (with the consent of trust remainder beneficiaries). That is the situation addressed by the Tax Court in *Anenberg v. Commissioner*, 162 T.C. No. 6 (May 20, 2024).

QTIP trusts created for the surviving wife (W) by her deceased husband (H) at his death in 2008 were terminated by a state court and all trust assets were distributed to W (with the consent of the remainder beneficiaries, H's sons by a prior marriage) in March 2012. The assets included almost half the stock of a closely held company (Company). In August 2012, W gave about 6.4% of the stock she received from the QTIP trusts to trusts for H's sons. In September 2012, W sold almost all the remaining stock of the Company to trusts for H's sons and grandchildren in return for nine-year secured and partially guaranteed promissory notes bearing interest at the applicable federal rate.

W timely filed a gift tax return for 2012 reporting the August 2012 gifts to the sons and reporting the September 2012 sales as non-gift transactions. W died before the IRS's examination of the 2012 return was completed, and the IRS proceeded with its gift tax claims against W's estate.

The IRS claimed that W owed more than $9 million of gift tax (and a penalty of $1.8 million) under two theories: (i) the termination of the QTIP trusts was a disposition of W's qualifying income interest resulting in a gift under §2519; or (ii) the termination of the QTIP trusts and W's subsequent sale of the stock received from the QTIP trusts resulted in a deemed transfer under §2519. Section 2519 provides generally that a disposition of any portion of the spouse's "qualifying income interest for life" is treated as a transfer of all the remainder interest in the trust.

The Tax Court unanimously rejected both positions (granting W's estate's motion for partial summary judgment and rejecting the IRS's motion for partial summary judgment). The court's analysis was grounded in its view of the "QTIP Regime" to defer transfer taxation for assets passing to a QTIP trust until the death of or gift by the surviving spouse," which is effectively "a legal fiction under which the surviving spouse is treated as receiving all of the QTIP passing from the deceased spouse." Opinion at 4. With this backdrop, the court reasoned: (i) no gift occurred at the termination of the QTIP trusts when the assets were distributed to W, because even if a "transfer" occurred under §2519, no gift resulted because W ended up owning all of the trust assets; and (ii) no deemed transfer under §2519 applied upon the sale of the assets because following the termination of the QTIP trusts, the qualifying income interest for life terminated, and there could be no disposition of something that did not exist.

The court distinguished cases, regulation examples, and rulings cited by the IRS, because they involved situations in which the spouse received nothing in return for the disposition of the income interest or received only the value of the income interest. The result in those cited situations "resulted in one-time taxation of the value of the remainder interests." In contrast, under the *Anenberg* facts, the spouse received all of the trust assets outright, which would subsequently be subject to transfer tax, resulting in double-taxation if a current gift tax on the value of the remainder interest was also imposed under §2519.

The court did not address whether a different result would occur if the trust termination and sale were part of an integrated transaction (the court noted that the IRS did not argue that the "substance over form" doctrine applied) (see Opinion at 25). Also, in footnote 18 the court expresses no view on whether H's sons made a gift by consenting to the termination and distribution to W of all trust assets. (That issue is raised in a pending Tax Court case, *McDougall v. Commissioner* (Tax Court Docket Nos. 2458-22, 2459-

22, and 2460-22), the same case in which the IRS had expressed its litigating position in CCA 202118008.) In addition, footnote 3 clarifies that because the court determined that no gifts resulted under §2519, the court did not have to address whether adequate disclosure had been made on the 2012 gift tax return such that the assessment of additional gift tax was barred by limitations.

Anenberg v. Commissioner, 162 T.C. No. 9 (May 20, 2024) (Judge Toro, with all judges in agreement).

2. Basic Facts

Alvin Anenberg (H) and Sally Anenberg (W) created a joint revocable trust that apparently included much (if not all) of their assets, including all the stock of a closely held company (Company) that owned and operated gas stations. H died in 2008, and various assets passed to Marital Trusts for the benefit of W, including almost half the stock of the Company. The remainder beneficiaries of the Marital Trusts following W's death were H's two sons by a prior marriage. H's executor made the QTIP election under §2056(b)(7).

In October 2011, one of the sons, as trustee of the QTIP trusts, filed a petition with a California state court to terminate the QTIP trusts and distribute all trust assets to W. "[A]ll beneficiaries (current and contingent)" consented to the court action. In March 2012, the court approved the termination and distribution to W of all the trusts' assets to W. At that time, the trusts' assets were worth $25.45 million and W's income interest was worth $2,599,463 (or 10,214% of the trust value, suggesting that W was 81 years of age at that time because the value of a life income interest in a trust for an 81 year-old person in March 2012, when the §7520 rate was 1.40%, was 10.214%).

In August 2012 (five months after the termination and distribution of the QTIP trusts' assets to W), W made a gift of about 6.4% of the shares of the Company she received from the QTIP trusts to trusts for the sons. In September 2012 (six months after the termination), W sold virtually all her remaining shares in the Company (including the roughly 50% that she had owned directly prior to H's death) to trusts for H's sons and grandchildren. Her sale proceeds were nine-year secured and partially guaranteed promissory notes with interest at the applicable federal rate (0.84%).

W timely filed a gift tax return for 2012, reporting the August 2012 gifts to trusts for the sons, and reporting the September 2012 sales as non-gift transactions.

The IRS reviewed the gift tax return, but W died in 2016 before the examination was completed. On December 1, 2020 (more than seven years after the gift tax return was filed), the IRS issued a Notice of Deficiency against W's estate determining that W was liable for more than $9 million gift tax "as a result of the termination of the Marital Trusts and the subsequent sales of the [Company] shares" (under §2519) with an accuracy related penalty of over $1.8 million. In the Tax Court proceeding, the IRS's second amended answer alleged for the first time an alternative argument that the termination of the QTIP trusts by itself was a disposition of W's qualifying income interest for life, triggering gift tax liability as a result of the deemed transfer of the remainder interest under §2519.

W's estate filed motions for partial summary judgment addressing each of the IRS's two arguments and asking the court to determine "that (i) the termination of the Marital Trusts and the distribution of the assets of the Marital Trusts to Sally did not result in a deemed gift under [section] 2519; [and that] (ii) Sally's sale of the [Company] shares received from the Marital Trusts in exchange for promissory notes did not result in a deemed gift under [section 2519]." (court's quotation of the motion). The IRS filed motions for partial summary judgment seeking the opposite results.

3. Holdings That No Gift Tax Results From Alleged Section 2519 Deemed Transfers

a. **Termination and Distribution to W of QTIP Trusts Assets**. "Assuming there was a transfer of property under I.R.C. § 2519 when the marital trusts were terminated, [W's estate] is not liable for gift tax under I.R.C. §2501 because W received back the interests in property that she was treated as holding and transferring under I.R.C. §§ 2056(b)(7)(A) and 2519 and made no gratuitous transfer, as required by I.R.C. §2501."

b. **Sale of Company Shares**. "[W's estate] is not liable for gift tax on the sale of [Company] shares for promissory notes because after the termination of the marital trusts [W's] qualifying income interest for life in QTIP terminated and I.R.C. § 2519 did not apply to the sale."

4. Court Analysis of Section 2519 Issues

a. **QTIP Regime.** The policy behind the marital deduction is to allow property to pass untaxed to a spouse, but to apply a transfer tax when property passes from the spouse (either at the spouse's death or by a gift from the spouse). The terminable interest rule is designed to deny a marital deduction in situations when the estate tax would not apply at the spouse's subsequent death.

The QTIP regime is an exception to the terminable interest rule allowing a marital deduction even though the surviving spouse only receives an income interest for life and has no control over the ultimate disposition of the property if the executor makes an election to opt into the QTIP regime so that estate or gift tax will apply when the property passes from the QTIP trust to beneficiaries designated by the first spouse to die. The QTIP rules "create a legal fiction under which the surviving spouse is treated as receiving all of the QTIP, when in reality the surviving spouse acquired only a lifetime income interest in that property." Opinion at 4. The court reiterates that that this "QTIP regime" in effect "creates a legal fiction under which the surviving spouse is treated as receiving all of the QTIP passing from the deceased spouse, when in reality the surviving spouse has acquired only a lifetime income interest in that property." Opinion at 10. The court quotes from *Morgens v. Commissioner*, 678 F.3d 769 (9th Cir. 2012), *aff'g* 133 T.C. 402 (2009):

> The underlying premise of the QTIP regime is that the surviving spouse is deemed to receive and then give the entire QTIP property rather than just the income interest. The purpose of the QTIP regime is to treat the two spouses as a single economic unit with respect to the QTIP property while still allowing the first-to-die spouse to control the eventual disposition of the property.

678 F.3d at 771.

The court observes that "[o]ther Code provisions continue the fiction that the surviving spouse owns the QTIP outright to ensure that if not consumed by the surviving spouse during her lifetime, the QTIP ultimately is subject to either the estate or gift tax." Opinion at 10.

Observation: An interesting article emphasizes the "tax fiction" created by the QTIP regime that in effect treats the spouse as owning the trust assets for transfer tax purposes, as referenced in *Anenberg*. Irwin, *Removing the Scaffolding: The QTIP Provisions and the Ownership Fiction*, 84 NEB. L. REV. 571 (2005).

b. **Section 2519.** Section 2519 addresses the manner in which a transfer tax is applied to QTIP assets when there is a disposition during life rather than at death. In relevant part, §2519 provides as follows:

> Sec. 2519(a). General Rule.—For purposes of this chapter [imposing the gift tax] and chapter 11 [imposing the estate tax], any disposition of all or part of a qualifying income interest for life in any [QTIP] shall be treated as a transfer of all interests in such [QTIP] other than the qualifying income interest.

Accordingly, for gift and estate tax purposes, §2519 treats any disposition of the spouse's income interest as if the surviving spouse transferred 100% of the remainder interests in the QTIP.

The court emphasizes, however, that §2519 merely results in a deemed "transfer" of the assets, but a gift does not occur that is subject to gift taxation if property is transferred in exchange for full and adequate consideration in money or money's worth. Reg. §25.2511-1(g)(1).

c. **IRS Position.** The IRS contended that W disposed of her qualifying income interest for life, thus triggering a deemed transfer of the remainder interest under §2519 at one of two times: (i) when W agreed to the termination of the QTIP trusts and accepted complete ownership of the QTIP trusts, or (ii) when W, having accepted the QTIP assets, sold them in exchange for promissory notes.

Furthermore, the IRS contended that this triggering of §2519 treats W as transferring the full value of the QTIP assets less only the value of her qualifying income interest, and the full value of the QTIP remainder interest is treated as a gift.

d. **Taxpayer Position.** W's estate argued (i) the 2012 transactions are not a disposition of a qualifying income interest but merely a conversion into an equivalent interest in other property (thus, §2519 does not apply), and in the alternative (ii) even if there was a disposition, no gift resulted because W received full and adequate consideration for the property she was deemed to transfer.

e. **Court Analysis of the Parties' Positions Regarding Termination of QTIP Trusts and W's Acceptance of QTIP Assets.** The court does not decide if the termination of the Marital Trusts, followed by W's acceptance of the QTIP assets was a "disposition" with the meaning of §2519(a). The court said it did not need to resolve that question because it reasoned that even if there is a deemed transfer of the remainder interest under §2519, no gift resulted that is subject to gift taxation. Section 2519 may treat certain events as a deemed "transfer" of the remainder interest, but gift tax is imposed under § §2501 only "on the *transfer* of property *by gift* during [the] calendar year." Opinion at 14 (emphasis in original). Any deemed transfer of the remainder interest in the Company shares owned by the QTIP trusts that may have occurred under §2519 did not result in a gift because W ended up with all those shares unencumbered.

> … [W's] deemed transfer of the remainder interest in the [Company] shares held in trust … resulted in her actual receipt of all the [Company] shares unencumbered …. At the end of the day, she gave away nothing of value as a result of the deemed transfer. Accordingly, the termination of the Marital Trusts did not result in any "gratuitous transfers" by [W], deemed or otherwise. [Citation omitted] Because there was no gratuitous transfer, she made no gift.
>
> …
>
> Before the termination of the Marital Trusts, [W] held a qualifying income interest for life in the QTIP. She was deemed for estate and gift tax purposes to hold the remainder interests as well. But these interests, even when considered together, did not equate to unencumbered ownership. She was not free to do what she wished with the QTIP, which was held in the trusts. After the Superior Court order, [W]received the QTIP free of any trust restrictions. In these circumstances, to the extent section 2519 viewed [W] as transferring away the interests in property that the QTIP regime treated her as holding in the first place, it is hard to understand why [W] would not have received full and adequate consideration in return when she was also at the receiving end of the transfer of the property unencumbered. Before the Marital Trusts terminated, she actually held an income interest in the Marital Trusts' property valued at approximately $2.6 million, but was deemed to hold the entirety of the Marital Trusts' property valued at approximately $25.5 million. Immediately after the Marital Trusts terminated and (we assume) [W] was deemed to transfer the residual value of the Marital Trusts' property (approximately $22.9 million), she actually held assets valued at approximately $25.5 million. [W] could thus be viewed as fully compensated for whatever interest she was deemed to transfer.

Opinion at 15, 17-18

Considering all the facts of the case bolsters that conclusion: (i) no value passed to any else; and (ii) any purported gift would have been an incomplete gift because the termination was conditioned on W receiving all the trust assets, so she could control their further disposition, Reg. §25.2511-2(b).

f. **Court Analysis of Parties' Position Regarding Subsequent Sale of Assets Received from QTIP Trusts.** The court cited two reasons that W's subsequent sale of Company shares she received on termination of the QTIP trusts did not trigger the application of §2519.

First, if the termination of the QTIP trusts was a disposition of W's qualifying income interest, that would have triggered §2519, and it would no longer apply to a subsequent transfer. "[H]er future transactions in the [Company] shares would be covered by the ordinary estate and gift tax rules rather than the QTIP regime."

Second, if the termination of the QTIP trusts was not a disposition triggering §2519, the QTIP trusts no longer existed at the time of the sale, so a qualifying income interest for life no longer existed, thus "eliminating the mechanism needed to trigger section 2519 in the future." Opinion at 19. (Footnote 21 states that the gift of shares in August 2012 did not trigger §2519 for the same reason.)

g. **Responses to IRS's Arguments** The court responded directly to various IRS arguments made to support its position.

(1) **Consideration of the QTIP Regime.** The court rejected the IRS's position that §2519 itself "imposes gift tax," because §2519 merely results in a deemed "transfer," but §2501 imposes

gift tax only on transfers "by gift." Congress used the phrase "transfer by gift" in other Code sections that directly resulted in gift taxation. *E.g.*, §2056A(b)(13) (treating lifetime distributions from a qualified domestic trust "as a transfer by gift").

This result makes sense under the QTIP regime concepts, to permit deferral of transfer taxation until the death of or gift by the surviving spouse.

> Where, as here, a surviving spouse receives the QTIP with respect to which she is deemed to transfer remainder interests, the value of the marital assets is preserved in her estate and will be taxed upon her death, assuming she does not consume the property or transfer it by gift at a later date. This is the same result that obtains when the marital deduction applies without regard to the QTIP regime.

The IRS cited various cases (*Morgens*, *Novotny*, and *Kite*), rulings (Rev. Rul. 98-8), and examples from regulations (Reg. §25.2519-1(a), (f), (g) (examples 1 and 2)) to support its position that gift tax should be imposed whenever a surviving spouse disposes of her qualifying income interest in QTIP. However, in those various sources, "the surviving spouse either disposed of the entire qualifying income interest by gift (i.e. for no consideration whatsoever) or else received consideration for the value of the income interest only." The key policy conclusion from those sources is that a gift tax would be imposed if "the value of the remainder interest in QTIP would have passed out of the surviving spouse's hands (and thus out of the marital unit) without ever being subject to estate or gift tax, contrary to the policy underlying the martial deduction and QTIP rules." Opinion at 21. But in this case, W's "receipt of the QTIP (and later the promissory notes) preserves the value of the marital assets in her hands for future gift or estate taxation." Opinion at 22. Indeed, the termination of the QTIP trust and distribution of its assets to the spouse is somewhat analogous to the appointment of assets to the spouse under a power of appointment, which Reg. §25.2519-1(e) specifically says is not a disposition that triggers §2519.

(2) **Regulation §25.2519-1(a).** The IRS cited Reg. §25,2519-1(a) to support its view that a disposition of any part of the qualifying income interest in a QTIP trust results in a deemed gift of the remainder interest. The second and third sentences of that regulation are as follows:

> For example, if the donee spouse makes a disposition of part of a qualifying income interest for life in trust corpus, the spouse is treated under section 2519 as making a transfer subject to chapters 11 and 12 of the entire trust other than the qualifying income interest for life. Therefore, the donee spouse is **treated as making a gift** under section 2519 of the entire trust less the qualifying income interest, and is treated for purposes of section 2036 as having transferred the entire trust corpus, including that portion of the trust corpus from which the retained income interest is payable.

Reg. §25.2519-1(a) (emphasis added).

While the third sentence says the spouse is treated as making a "gift" of the remainder interest, it does not say §2519 deemed transfers are always treated as gifts. The third sentence merely

> completes the example posited by the second sentence, in which the donee spouse has disposed of part of a qualifying income interest for life, presumably for no consideration or for consideration matching the value of the disposed-of partial interest. (That is why the third sentence refers to the "trust corpus" rather than "property" and the donee spouse's "retained income interest.")

Opinion at 24. The third sentence does not state a general rule for all §2519 purposes; the general rule is in the first sentence, which provides simply that "the donee spouse is treated … as *transferring* interests in property other than the qualifying income interest." Reg. §25.2519-1(a) (emphasis added).

(3) ***Estate of Kite.*** IRS attacks under §2519 on QTIP trust planning have intensified following the Tax Court's opinion in *Estate of Kite v. Commissioner*, T.C. Memo. 2013-43, and the IRS "makes much of" *Kite* in this case. *Kite* involved rather complicated facts, but in very simple terms, in a three-day series of planned transactions, the wife-beneficiary of QTIP trusts appointed her children as trustees, they terminated the trusts and distributed all trust assets to the wife, and the wife sold the assets to her children for a deferred private annuity (payment would not begin for 10 years and the wife died before receiving any payments). The court determined that the value of deferred annuity was full and adequate consideration for sale of the QTIP trust assets. The *Anenberg* opinion summarized *Kite* as follows:

> … this Court (at the Commissioner's urging) applied the substance over form doctrine to treat the transactions as one integrated transaction … [a]nd, in doing so, the Court concluded that the termination of the trust and subsequent sale of property was a disposition for purposes of section 2519(a).

Anenberg distinguished Kite on two grounds. (1) *Kite* applied the substance over form doctrine, and (2) because of the sale of QTIP assets for the deferred private annuity in *Kite*, it "involved an apparent attempt to prevent estate or gift tax from ever being imposed on the residual value of the QTIP." Neither of those applied in *Anenberg*. (*Kite* is discussed further in Item 5.e below.)

(4) **No Consideration.** The IRS reasoned that the value of the Company shares were already included in W's taxable estate before the termination of the QTIP trusts, so the receipt of the Company shares could not have constituted adequate and full consideration "because she was already deemed to own them." The court viewed this a "wanting to have your cake and eat it too" argument by the IRS.

Under the QTIP regime, the value of the Company shares were included in W's estate before the QTIP trusts were terminated, and the court acknowledged that "section 2519(a) deemed [W} as giving up the remainder interests that she previously was deemed to have received from [H]. This in turn resulted in a (temporary as we will momentarily see) diminution of her estate." But that was only half the story.

> But the transaction did not stop there, and our analysis is not yet finished. The Superior Court ordered that all of the property held by the Marital Trusts be distributed to [W]…. The receipt of those shares "replenished" or "augmented" her (temporarily) diminished estate. In analyzing the tax consequences of the deemed transfer section 2519 contemplates, we cannot ignore that, as part of the same transaction, [W] in fact wound up with the unencumbered [Company] shares. We therefore decline the Commissioner's invitation to decide the case by taking into account only half of the relevant transaction.

Opinion at 26-27.

5. Observations

a. **Major Blow to IRS Attacks Under §2519.** Ever since the Tax Court's decision in *Kite v. Commissioner* over ten years ago, the IRS has increasingly been making §2519 attacks on planning involving existing QTIP trusts. The holdings and reasoning in the unanimous reviewed Tax Court opinion in *Anenberg*, delivered merely three months after the hearing on the motions for partial summary judgment, are a major blow to §2519 arguments the IRS has been making. If all the QTIP trust assets are distributed to the spouse-beneficiary, who later engages in transfer planning transactions, §2519 will not result in a deemed gift of the remainder interest subject to gift tax (at least if the termination/distribution/ transfer transactions are not part of an integrated plan under the substance over form doctrine – more about that in Item 5.c below). The court's focus on the "QTIP regime," the tax fiction treating the spouse as owning the QTIP trust assets, and the key policy of deferring transfer taxation until the surviving spouse's subsequent death (or gifts) but avoiding results that result in double taxation may be the guidepost for future decisions.

b. **Commutations.** Commutation transactions, in which a QTIP trust is terminated by paying the beneficiaries the actuarial values of their respective interests, will continue to be subject to §2519 attacks. If the spouse-beneficiary is merely paid the actuarial value of his or her qualifying income interest for life, the reasoning in *Anenberg* specifically indicates that §2519 generally will apply, and the spouse will be treated as making a gift of the value of the remainder interest.

Anenberg reasons that because the spouse received *all* the QTIP trust assets, the spouse did not make a gift. To the extent the spouse does not receive all the QTIP assets, the difference would be a gift (either of a portion of the income interest or, more likely, of the remainder interest under §2519).

Footnote 17 in *Anenberg* specifically says that Section 2519 would apply and a taxable gift of the remainder interest would result in the classic commutation situation in which the spouse receives just the actuarial value of her income interest.

> The result would be different if [W] had received only the value of her qualifying income interest for life when the Marital Trusts terminated. In such a case, [W] would have been left with assets valued at approximately $2.6

> million. The gratuitous transfer under section 2519 would be plain (although deemed) and would total approximately $22.9 million ($25.5 million of assets deemed held before the termination less her $2.6 income interest).

An extension of *Anenberg* is what would happen if the spouse received more than just the value of the qualifying income interest for life, but less than the full trust value. The reasoning in *Anenberg* suggests that the spouse makes a gift only to the extent that a "gratuitous transfer" is made. For example, assume a $100 QTIP trust is terminated and the spouse receives $40 even though the value of her income interest is only $20. If that is treated as a disposition of any portion of the income interest that triggers §2519, is the spouse treated as making a gift of the full value minus the value of the income interest ($100 - $20 = $80)? That would not make sense under the *Anenberg* reasoning, because the spouse was deemed to own $100 under the "legal fiction" of the QTIP regime and ends up owning $40 after the transaction. How does a gratuitous transfer occur of more than $60 ($100 owned before the transaction - $40 owned after)? The court's emphasis on the "gratuitous transfer" requirement suggests that a gift tax would not be imposed on the full value of the remainder interest.

Observe, that conclusion appears to be a repudiation of *Kite II*, which refused to allow any offset in the determining amount of gift resulting from a §2519 transfer for amounts received by the spouse in a transfer that triggers §2519. See Item 5.e(2) below.

c. **Step Transaction Doctrine.** The court's reasoning to distinguish *Kite* from this case is in part that *Kite* involved a substance over form argument which the IRS did not allege in this case. (In *Kite*, the termination of the QTIP trusts, the distributions of all assets to the surviving wife, and the sale by the wife for the deferred private annuity all occurred within a *three-day* span, whereas the gifts and sales of the QTIP trust assets in *Anenberg* occurred five months and six months, respectively, after the trust termination.)

Even if trust termination and a *sale* of the assets received from the trust are treated as integrated transactions, the spouse may not be treated as making a gift of the remainder interest under §2519 under the reasoning of *Anenberg*. The court reasoned that the deemed transfer of the remainder interest when §2519 is triggered results in a gift for gift tax purposes under §2501 only to the extent it is a "gratuitous transfer." If the spouse ends up with promissory notes having a current value equal to the value of the QTIP trust assets, presumably no gratuitous transfer occurs.

On the other hand, if a QTIP trust termination and *gift* of assets are treated as an integrated transaction, a gratuitous transfer would occur and some taxable gift may result under §2519. However, the gift may result only as to the gifted assets, and not the full remainder value of the trust, because the spouse would still own the remaining QTIP trust assets that had been distributed to her following the QTIP trust termination. Those assets will be subject to transfer tax when the spouse subsequently dies or makes a gift of the assets, and the underlying premise of the QTIP regime and purpose of assuring that the QTIP trust assets will eventually be subject to a transfer tax would be served without imposing gift tax on the entire remainder interest under §2519 at the time of a gift of some portion of the assets in connection with the trust termination. That goes to the issue of whether *Anenberg* repudiates *Kite II* (as discussed in Item 5.e(2) below). Treating the full remainder interest value as a taxable gift currently and subjecting the remaining assets to a transfer tax at death or up a later gift would result in double taxation of that value. The court's summary in *Anenberg* suggests that double taxation would not be appropriate.

> To summarize, in each of the Commissioner's cited sources, imposing the estate or gift tax resulted in *one-time taxation* of the value of the remainder interests in QTIP at the time that value left (or was deemed to leave) the surviving spouse's hands.

Opinion at 28 (emphasis added).

d. **Gift by Remainder Beneficiaries Who Consent to All QTIP Assets Being Distributed to Spouse-Beneficiary; CCA 202128008; *McDougall v. Commissioner*.** A significant risk exists that the remainder beneficiaries may be treated as making a taxable gift to the spouse by consenting to the spouse receiving all the trust assets rather than just the actuarial value of her lifetime income interest. *See* CCA 202352018 (consent by beneficiaries to add tax reimbursement clause to a grantor trust in a judicial trust modification action would constitute a gift by the beneficiaries of a portion of their respective interest in the trust).

A possible response to that argument is that the legal fiction created under the QTIP regime is that the surviving spouse is treating as owning the assets of the QTIP trust for tax purposes. While the children may have interests under state law as trust remaindermen, the surviving spouse is treated as the owner of the assets for tax purposes under the fiction of the QTIP regime. How can one make a gift of an asset to a donee who already owns the asset for tax purposes?

The IRS took the position in CCA 202128008 that trust remaindermen made a gift when they consented to the surviving husband receiving all the QTIP trust assets in a nonjudicial settlement agreement terminating the QTIP trust. For a detailed discussion (and strong criticism) of CCA 202118008, see Item 8.h of Estate Planning Current Developments (March 16, 2022) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.**

Three cases (involving the surviving husband and each of the two children who were trust remaindermen) addressed in this CCA are pending in the Tax Court and have been consolidated for trial. *McDougall v. Commissioner*, Docket Nos. 2458-22, 2459-22, and 2460-22 (Petitions filed February 18, 2022, Judge Halpern). (The taxpayers are represented by John Porter, Keri Brown, and Tyler Murray.) The court is now considering motions for summary judgment filed by the various parties. The Children argued that they should not be treated as making a gift but that the transaction was a reciprocal exchange for consideration. The IRS viewed the transaction as a two-step process. First, "the remainder interest vested outright, equally, in Children, the then remaindermen." Second, "Children then transferred their valuable property interest to Spouse and received nothing in exchange."

Motions filed in the case reflect the values involved in the transactions. The value of the QTIP trust at the time of the commutation was about $117.6 million. The Notices of Deficiency asserted that the surviving husband made a gift of the remainder interest under §2519 equal to about $106.8 million and the remainder beneficiaries made gifts in an equal amount back to the surviving husband. The surviving husband's gift tax deficiency was about $47.7 million and the remainder beneficiary's gift tax deficiency was about $43.4 million, resulting in total gift tax deficiencies of over $80 million. And the husband was left owning promissory notes equal to the value of the QTIP assets that would be subject to transfer tax in the future.

The surviving husband's motion for summary judgment summarized the IRS's position as follows:

> Despite the fact that Bruce's [Bruce was the surviving husband] gross estate remained unchanged, Respondent issued notices of deficiency asserting that the termination of the Residuary Trust and the distribution of its assets to Bruce resulted in two simultaneous taxable gifts of the same assets. First, in his notice of deficiency to Bruce, Respondent asserts that there was a "deemed" gift by Bruce to Linda and Peter [the children of Bruce and his deceased wife who are the contingent remainder beneficiaries] equal to the value of the remainder interest in the Residuary Trust for which gift tax is due. Second, in nearly identical notices of deficiency issued to Linda and Peter, Respondent asserts that there were simultaneous gifts by Linda and Peter, collectively, back to Bruce, consisting of the same assets and in the same amount as Bruce's gift to them, for which Respondent claims gift tax from each of Linda and Peter is due. Finally, under Respondent's theory, there will be a third tax on the value of those assets when Bruce subsequently transfers the assets by gift or upon his death.

The surviving husband's responses in his motion for summary judgment to the IRS's arguments are summarized.

(1) The nonjudicial agreement (NJA,) which resulted in the termination of the QTIP trust and distribution of its assets to the surviving husband, expressly invoked and followed the IRS's guidance for reciprocal gifts in Rev. Rul. 69-505, created offsetting reciprocal transfers of equal value, resulting in the surviving husband receiving the assets. The NJA expressly states that it (1) "results in a deemed gift, for federal gift tax purposes, of the remainder interest in the Trust assets from Bruce [the surviving husband] to Linda and Peter under Section 2519 of the Code," and (2) also results in a gift of the remainder interest in the trust from the remaindermen to the surviving husband. Those two gifts result "in a reciprocal gift transfer." "The simultaneous transfer of interests was part of an integrated transaction."

(2) Rev. Rul. 69-505 involved transfers by joint tenants to a trust. The ruling concluded that "[t]he transfers between the joint tenants are treated as a reciprocal exchange for consideration in money or money's worth…. Thus, neither is considered to have made a gift to the other to the extent that the transfers are of equal value."

(3) The QTIP regime conceptually creates a tax fiction in effect treating "the second spouse as owning the subject property outright, rather than owning merely a life or other terminable interest." *Estate of Sommers v. Commissioner*, 149 T.C. 209, 223-24 (2017). The NJA produced the same result as if the assets had been left outright to the husband rather than in the QTIP trust "and thus should have the same transfer tax consequences because the value of the assets included in [the surviving husband's] gross estate remained unchanged by the execution of the NJA," and the husband's sale of the assets in exchange for promissory notes left the value in his gross estate unchanged. In effect, the husband's acquisition of all the assets of the terminated QTIP trust as a result of the NJA left "the surviving spouse's real world **unchanged** from the 'tax fictional' world that evaporated when the QTIP terminated." (Emphasis in original). *See* Irwin, *Removing the Scaffolding: The QTIP Provisions and the Ownership Fiction*, 84 NEB. L. REV. 571 (2005) (emphasizing "tax fiction" of spouse ownership of QTIP assets for transfer tax purposes under the QTIP regime).

(4) The taxpayer distinguished *Kite* because it would have resulted in a transfer without gift or estate tax because of the deferred private annuity coupled with a premature death if gifts had not occurred under §2519. In contrast, in *McDougall* no transaction occurred in which the children received assets of the trust in a manner that would result in no gift or estate tax upon the husband's transfer of the assets because the promissory notes are subject to transfer tax.

(5) The rationale of Rev. Rul. 98-8, 1998-7 I.R.B. 24, is consistent with the taxpayer's position. In Rev. Rul. 98-8, the surviving spouse's purchase of the remainder interest in the QTIP trust was treated as a gift to the remainder beneficiaries equal to the purchase price paid because the assets comprising the remainder interest were already included in the surviving spouse's gross estate. Under the QTIP regime, the remainder was already owned by the spouse (i.e., it was in the spouse's gross estate), so "nothing was acquired by the surviving spouse for the consideration paid and the surviving spouse's gross estate was diminished." That is not the result in the *McDougall* facts; the surviving husband's gross estate was not diminished.

(6) The position of the IRS results in triple taxation that is inconsistent with the structure and purposes of the QTIP rules.

> **In light of this, Respondent's position that would tax the same asset twice in the same day in a back-and-forth transfer and, for a third time, when the patriarch passes away (which could theoretically cause the triple transfer taxation of the property on the same day) is preposterous.** Bruce will be subject to estate tax on the value of the Residuary Trust received upon its termination, unless those assets are consumed or the object of a subsequent *inter vivos* taxable gift, which is the same circumstance that would have resulted had the Residuary Trust been left undisturbed. Perhaps the better analogy is that this is the same outcome that would have arisen had the surviving spouse been given the assets outright; or, in a more flexible variation of the standard QTIP marital trust, where a fiduciary is given the power to terminate the trust in favor of the surviving spouse at its discretion. Why should the termination of the QTIP trust through the NJA give rise to more than a single incident of taxation? The answer is that it should not. Taxpayer consistency does not support such an outcome, and Respondent's **attempt to achieve triple taxation** is contrary to the IRS's own published guidance applicable to these situations, further undermining confidence in the tax system. Similarly, Linda and Peter have not reduced their potential estate tax obligations, as their gross estates would be taxed on the assets of the Residuary Trust only to the extent of gifts or bequests from Bruce. This is the same circumstance that would have existed had the Residuary Trust been left undisturbed. (Emphasis added)

(7) In response to an IRS alternative argument that the husband's sale of substantially all the QTIP assets in exchange for promissory notes resulted in a disposition of his qualifying income interest in the trust, thus triggering §2519, the taxpayer argued that the husband did not relinquish his income interest. The receipt of the promissory notes was not a disposition of a qualified income interest but was the conversion of QTIP property into other property in which the husband holds an income interest. *See* Treas. Reg. §§ 25.2519-1(f) ("conversion of qualified terminable interest property into other property in which the donee spouse has a qualifying income interest for life is not, for purposes of this section, treated as a disposition of the qualifying income interest"); 25.2519-1(e) (exercise of a

power to appoint QTIP assets from the trust to the surviving spouse is not treated as a disposition under §2519).

e. **Impact of *Kite v. Commissioner*.**

(1) ***Kite v. Commissioner* Brief Summary.** Mrs. Kite ("Wife") created a QTIP trust for Mr. Kite ("Husband") who died a week later. (Presumably, that inter vivos QTIP trust was created to obtain a basis adjustment at Husband's death, despite the limitations imposed by §1014(e).) Under the terms of the trust the assets remained in the QTIP trust for Wife's benefit, and Husband's estate made the QTIP election to qualify for the estate tax marital deduction.

Subsequently, the assets of the QTIP trust as well as another QTIP trust and a general power of appointment marital trust (collectively the "Marital Trusts") were invested in a limited partnership. Eventually the trusts' interest in a restructured partnership was sold to the Wife's children (and trusts for them) for notes and the notes were contributed a general partnership. In a three-day series of planned transactions, Wife replaced trustees of the Marital Trusts with her children as trustees, the children as trustees terminated the Marital Trusts (effective three months earlier) and distributed all of the trust assets (i.e., the interest in the general partnership) to Wife's revocable trust, the children contributed additional assets to the general partnership, and Wife (almost age 75) sold her partnership interests to her children for a deferred private annuity (annuity payments would not begin for 10 years). Wife died three years later before receiving any annuity payments.

(The children's authority as trustees to terminate the Marital Trusts and distribute all the assets to Wife is unclear. The opinion describes the principal distribution standards for the QTIP trust that Wife originally created but not for the other trusts. Principal from that QTIP trust could be distributed for "maintenance" and the trust could be terminated if the trust corpus was too small to justify management as a trust.)

The court's initial decision, *Kite v. Commissioner*, T.C. Memo. 2013-43 (decision by Judge Paris) (referred to as "*Kite I*"), held as follows.

1. The transfer of assets in return for the private annuities was for full consideration, was not illusory, and did not lack economic substance. Using the IRS actuarial tables was appropriate, even though the annuity payments would not begin for 10 years and Wife had only a 12 1/2 year life expectancy, because Wife was not terminally ill at the time of the sale and she had at least a 50% chance of living more than one year. The sale was not illusory and was bona fide because the annuity agreement was enforceable and the parties demonstrated their intention to comply with the annuity agreement. "The annuity transaction was a bona fide sale for adequate and full consideration."

2. The transfer of assets from the QTIP Trusts to a limited partnership in return for limited partnership interests, the subsequent reorganization of the partnership as a Texas partnership (to save state income taxes), and the trusts' sale of the interests in the general partnership in return for 15-year secured notes did not constitute a disposition triggering §2519.

3. The liquidation of the QTIP trusts and the sale of the interests in the general partnership for the private annuities were part of an integrated transaction that was deemed to be a disposition of her qualifying income interest for life, that triggered §2519 and in turn caused a deemed transfer of the remainder interests in the QTIP trusts. The deemed transfer of the income interest was not a taxable gift under §2511 because Wife received full value. *Kite I* did not discuss what, if any, taxable gift resulted from the deemed transfer of the remainder interest. (The effect of the transfer of the income interest is determined under the general gift tax principles of §2511—the value of the portion of the income interest that is transferred less the consideration received for such transfer).

4. The transfer of assets from the general power of appointment marital trust to Wife was not a release of her general power of appointment causing a transfer under §2514 for gift tax purposes. The court only considered the termination of the marital trust and did not also

consider the subsequent private annuity transaction as part of an integrated transaction in determining tax consequences of the transactions involving the general power of appointment marital trust.

Kite II is the court's Order and Decision regarding the Rule 155 computations of the gift tax as a result of the decision in *Kite I*. (Cause No. 6772-08, unpublished op. Oct. 25, 2013). The estate argued that no gift resulted from the deemed transfer of the remainder interest under §2519 because of the court's decision in *Kite I* that the Wife's sale of assets that she received from the QTIP trust in return for a deferred private annuity was a bona fide sale for adequate and full consideration.

Despite countervailing indications in the statute, regulations, and legislative history, the court in *Kite II* interpreted §2519 to mean that the full amount of the deemed transfer of the QTIP trust remainder interest is a gift, regardless of any consideration received by the surviving spouse. "[A] deemed transfer of a remainder interest under section 2519 cannot be made for adequate and full consideration or for any consideration."

The conclusion in *Kite II* that the amount of the *gift* resulting from the deemed *transfer* of the remainder interest was not offset by any payments made to the spouse was strongly criticized at the time is was published. *See Recent Developments*, 48th ANN. HECKERLING INST. ON EST. PL. (2014) (Ronald Aucutt ed.). Most planners and commentators had believed following *Kite I* that a zero gift would result from the deemed transfer of the remainder interest considering the court's determination that the wife received full value (an annuity) when she transferred the assets of the QTIP trust. *See e.g.,* Jeffrey Pennell, *Jeff Pennell on Estate of Kite: Will It Fly?* LEIMBERG EST. PL. EMAIL NEWSLETTER, Archive Message #2062 (February 11, 2013).

For a more detailed discussion of *Kite I* and *Kite II*, see Akers, *Kite v. Commissioner*, Rule 155 Order and Decisions (Cause No. 6772-08, unpublished opinion October 25, 2013) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights)**.

(2) **Does *Anenberg* Repudiate *Kite II*.** *Anenberg* goes a long way toward repudiating *Kite II* in many situations. *Anenberg* very clearly concludes that, at least in situations in which the entire QTIP trust assets are distributed to the spouse in a judicial termination of the trust, if there is a disposition of any of the qualifying income interest for life that results in a deemed "transfer" of the remainder interest under §2519, no taxable gift results of the remainder interest if the surviving spouse receives all the trust assets. No "gratuitous gift" has occurred, so no taxable gift of a deemed transfer of the remainder occurs following the disposition.

Whether that same result would apply if the termination of the trust and distribution of assets to the spouse and a sale by the spouse of the trust assets are treated as an integrated transaction under the "substance over form" doctrine was not addressed in *Anenberg*, but the reasoning in *Anenberg* would suggest that assets owned by the spouse following the integrated transaction (i.e., the promissory notes representing the sale proceeds) should offset any deemed gift of the remainder interest.

A further wrinkle in *Kite* is that the transaction involved a sale for a deferred private annuity with a structure that was planned to avoid subjecting any of the QTIP trust assets to estate or gift taxation, which is what happened in Kite because the Wife died before any annuity payments began and her annuity interest therefore terminated. Reducing the estate tax on the QTIP assets to zero was a byproduct of using a deferred private annuity sale transaction, but whether court after *Anenberg* would reach a differing result under §2519 on those facts cannot be known until a court rules directly on that situation.

f. **Income Tax Consequences.** *Anenberg* does not discuss the income tax consequences of the judicial termination of the QTIP trusts (presumably, the IRS did not raise the issue). The IRS views the early termination of trusts as income tax events. The remainder beneficiaries in the Letter Rulings 201932001-201932010 were treated as having purchased the interests of the life beneficiary and the contingent remainder beneficiaries (and the life beneficiary had a zero basis in his interest under the uniform basis rules of §1001(e) so the total amount paid to the life beneficiary was capital gain). The remainder beneficiaries, as the deemed purchasers, do not pay tax on amounts **received** in the commutation (as the fictional purchasers, they are just receiving what is left in the trust after they have bought out everyone else), but they "realize gain or loss on the property exchanged." So, they recognize gain on the assets **paid out** to others less the amount of their uniform basis attributable to those assets. Massive income taxation can result, which could be totally avoided by not terminating the trust early. For a detailed discussion of the 2019 letter rulings and the income tax effects of early terminations of trusts, see Item 16 of Estate Planning Current Developments and Hot Topics (December 2020) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

What the effect would be when the full trust value is paid to the income beneficiary is not clear. At least for income tax purposes, the remainder beneficiary may be treated as making a gift to the income beneficiary of the value of the remainder interest, which amount therefore would not be taxable income under §102(a). *See Commissioner v. Duberstein*, 363 U.S. 278, 284-286 (1960) ("detached and disinterred generosity"). Perhaps any deemed purchase by the remainder beneficiary would be limited to the value of the income interest. Query whether the amount of the remainder interest might be treated as a gift for income tax purposes (and therefore not taxable income under §102) but not a gift for transfer tax purposes (because for transfer tax purposes the spouse is treated as the owner of the full value of the QTIP assets under the legal fiction created in the QTIP regime).

g. **Planning Regarding Spouse's Interest in QTIP Trusts.** Planning for surviving spouses who are beneficiaries of substantial QTIP trusts is complicated but very important because assets remaining in a QTIP trust at the surviving spouse's death will be included in the spouse's gross estate for estate tax purposes. The §2519 issue appears to be a focus of the IRS. John Porter, one of the attorneys representing the taxpayer in *Anenberg* and *McDougall* (discussed in Item 5.d above), says he is aware of several of these types of cases currently in litigation. Various attorneys indicate they have pending examinations involving §2519.

For an outstanding detailed discussion of planning alternatives for a surviving spouse who is the beneficiary of a QTIP trust, see Read Moore, Neil Kawashima & Joy Miyasaki, *Estate Planning for QTIP Trust Assets*, 44th U. MIAMI HECKERLING INST. ON EST. PLAN. ch. 12 1202.3 (2010). For a discussion of other planning alternatives (including planning for distributions to the spouse, and the risks of unauthorized distributions, so the spouse can make estate planning gifts and transfers of those assets), see Item 9.h of Estate Planning Current Developments and Hot Topics 2022 (December 2022) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**. *See also* Richard S. Franklin, *Lifetime QTIPs—Why They Should Be Ubiquitous in Estate Planning*, 50th HECKERLING INST. ON EST. PL. ch. 16 (2016); Richard S. Franklin & George Karibjanian, *The Lifetime QTIP Trust – the Perfect (Best) Approach to Using Your Spouse's New Applicable Exclusion Amount and GST Exemption*, 44 BLOOMBERG TAX MGMT. ESTATES, GIFTS & TR. J. 1 (March 14, 2019).