

**2010 Heckerling Institute on Estate Planning Materials**

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## THE SETTling OF TRUST LITIGATION INVOLVING QTIP TRUSTS

### I. Background

- A. Estate and trust litigation may relate to non-QTIP issues, such as undue influence or challenges to testamentary documents, but involve QTIP trusts in the dispositive scheme. Surviving spouses may have as a primary or secondary objective the termination of a QTIP trust - that is, the desire to receive assets outright instead of in trust.
- B. Other litigation may directly involve the administration of QTIP trusts, such as litigation involving:
  - 1. Weighting of investments to produce income vs. principal (that is, whether the spouse or the remaindermen are unduly favored).
  - 2. Application of discretionary principal distribution standards.
  - 3. Dealing with ambiguous trust provisions.

These conflicts are exacerbated in second marriage situations (when children are the remaindermen and the spouse is not their natural mother).

- C. At some point, parties to the dispute will likely give consideration to modifying or terminating the QTIP trust, or changing beneficiaries, as a method of separating the warring parties and avoiding future conflicts and litigation.
  - 1. From a state law perspective, the terms of the QTIP trust itself, including spendthrift provisions and defined distribution terms, may limit the ability of the parties to willy-nilly modify or terminate the trust. However, if all interested parties are involved or consent, such modifications, terminations, or distributions can usually be accommodated under applicable local law, at least as part of a court-approved settlement agreement.
- D. Such modifications or termination follow certain patterns, each of which has different federal tax consequences. The patterns, which are analyzed in more detail below are:
  - 1. Direct disposition by the surviving spouse of his or her income interest by gift;
  - 2. Direct disposition by the surviving spouse of his or her income interest by sale/for consideration;
  - 3. Distributions of principal to the surviving spouse;

4. Dispositions of remainder interests by remainderman by gift;
5. Dispositions of remainder interests by remainderman by sale/for consideration;
6. Principal distributions to remainderman; and
7. Conversion of QTIP income interest to unitrust interest.

## II. 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. Code §2519.

1. Code §2519(a) 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 Code §2056(b)(7) or Code §2523(f). Code §2519(b).
2. Thus, a disposition of all or part of a qualifying income interest in a QTIP trust triggers Code §2519.<sup>1</sup> One such triggering disposition is a gratuitous transfer of all or part of the income interest. H. Rep. No. 201, 97th Cong., 1st Sess. 161 (1981).
  - a. Code §2519 will still apply, even if the disposition was not a gratuitous transfer - that is, even if the transfer was in exchange for other consideration received in settlement of litigation.
    - (1) In Field Service Advice 199916025, the IRS indicated Code §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 Code §2519 is triggered by a "disposition" and not just a "gift," and H. Rep. No.

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<sup>1</sup> 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 Code §2519. Treas.Reg. §25.2519-1(f).

201, *supra*, provides that the disposition can be by “gift, sale, or otherwise.” Note that such a disposition for consideration may incur gain or loss under Code §1001, as discussed in the disposition by *sale* portion of this outline at Section III below. H. Rep. No. 201, 97th Cong., 1st Sess. 161 (1981).

3. Code §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.
  - a. The surviving spouse’s gift tax liability from a Code §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. Code §§2502, 2001(b)(1)(B), 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 Code §2035(b), even if the tax is recovered under Code §2207A(b). *See Estate of Sachs*, 88 TC 79 (1987). Some commentators believe that Code §2519 can also trigger a tax under the generation skipping tax provisions of the Code absent a reverse QTIP election, even though Code §2519 refers only to the estate and gift tax chapters of the Code.
  - b. Attempting to avoid Code §2519 through a nonqualified disclaimer by the surviving spouse will not be effective. *See* PLR 200022031, June 5, 2000, which also dealt with measuring the amount of the gift under Code §§2518 and 2519.
4. Computing the amount of the taxable gift is a two step process.
  - a. Under the first step, the fair market value of all trust property is determined as of the disposition date. Treas.Reg. Section 25.2519-1(c)(1). This includes accumulated income.
  - b. Under the second step, the value of the spouse’s income interest is computed, and deducted from the fair market value of all trust property computed under the first step. Treas.Reg. Section 25.2519-1(c)(1). The remaining amount is the taxable gift.
  - c. Note that whether the gift is of all *or only a part* of the income interest, the same computation and taxable gift occurs.
  - d. The taxable gift is not eligible for exclusion, in whole or in part, as an annual exclusion gift. H Rept No. 97-201 (PL 97-34) pp. 161-162.
  - e. If only a portion of a trust is subject to a QTIP election, then the taxable gift amount is prorated. Treas.Reg. §25.2519-1(c)(2) & (3).
  - f. *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 1/2 of her income interest to Nancy, triggering a Code §2519 gift. Under the first step of the above computation, the fair market value of trust property is determined - \$1 million. Under the second stop, the value of Joan's income interest (\$400,000) is deducted from the \$1 million, resulting in a Code §2519 gift of \$600,000.

5. This taxable gift amount is subject to two potential adjustments.
  - a. The first relates to Code §2207A(b), which provides a right of recovery to the surviving spouse for any gift taxes arising from a Code §2519 gift. If the surviving spouse is entitled to recover any gift tax on the taxable gift under Code §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.
    - (1) This is because 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, thus reducing the gross amount gifted..
    - (2) Such adjustment is computed using the same interrelated computation that applies for other transfers under which a transferee assumes the gift tax liability. Treas. Regs. §25.2519-1(c)(4).
    - (3) The amount of tax recoverable under Code §2207A(b) does *not* include the portion of the taxable gift under Code §2519 that is covered by the surviving spouse's remaining unified credit. H Rept No. 97-201 (PL 97-34) p. 162.
  - b. The second potential adjustment relates to Code §2702. Code §2702 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.
    - (1) The Code §2702(d) limitation for partial transfers is likely inapplicable because the surviving spouse is deemed to transfer the entire remainder under Code §2519. A "member of the family" is defined in Code §2704(c)(2). Code §2702(e).
    - (2) 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 Code §2702, the actual value of the retained income interest is added to the Code §2519 taxable gift amount. Treas. Regs. §25.2519-1(g), Ex. 4.

#### B. Other Tax Consequences - Remainder Interest Segment

1. Failure to Enforce Code §2207A(b) Right of Recovery

- a. If the surviving spouse has a right of recovery of gift taxes under Code §2207A(b) relating to the deemed transfer of the remainder interest under Code §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. Treas. Regs. §25.2207A-1(b).
- b. This taxable gift could occur in a calendar year later than the Code §2519 gift of the income interest, since it generally does not occur until the right of recovery becomes unenforceable. Treas. Regs. §25.2207A-1(b).
  - (1) 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.

2. 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, Code §2038 may still apply to tax the remainder assets at the death of the surviving spouse. Stephens, Maxfield, Lind, Calfee & Smith, *Federal Estate and Gift Taxation*, Warren Gorham & Lamont (2008), at ¶10.08[1][a].

C. Other Tax Consequences - Income Interest Given Away Segment

1. In regard to the second part, the income interest that is gifted away, this gift also constitutes a *separate* gift under Code §2511, in addition to the gift arising under Code §2519. Treas.Reg. Section 25.2519-1(a).
2. The amount of this separate gift is the value of the income interest transferred, less any consideration paid for it.
  - a. In the context of the settlement of litigation, the transfer of the income interest may be considered to have been made for full and adequate consideration. In that circumstance, while Code §2519 will apply, a taxable gift of the income interest may not be applicable. *See* Field Service Advice 199916025 and the discussion at Section II.A.2.a.(1) above in regard to the application of Code §2519. See the discussion below at Section III.C.1 as to lack of a gift.
3. *Example:* Continuing the example above, Joan transferred 1/2 of her income interest to Nancy. Therefore, Joan is also treated as having made an additional gift of \$200,000 (1/2 of the \$400,000 value of the income interest under the QTIP trust).

D. Other Tax Consequences - Income Interest Retained Segment

1. 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 Code §2036. More particularly, the spouse is treated under Code §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."
  - a. However, there are arguments that the application of Code §2036 is unwarranted and these regulations are invalid. *See* Stephens, Maxfield, Lind, Calfee & Smith, *Federal Estate and Gift Taxation*, Warren Gorham & Lamont (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.' "]
2. This Code §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.
  - a. Treas.Reg. Section 25.2519-1(g), Ex. 4. This retained interest also gives rise to an adjustment to the surviving spouse's adjusted taxable gifts under Code §2001(b)(1)(B).
3. However, at the death of the surviving spouse, Code §2044 will not itself require any inclusion of the trust in the gross estate of the surviving spouse, since Code §2519 applied to the partial lifetime disposition. Code §2044(b)(2).
4. *Example:* Again continuing the example, since Joan retained 1/2 of the income interest, 1/2 of the trust value at her death will be included in her gross estate under Code §2036.

### III. Disposition of Income Interest - By Sale/For Consideration

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 be desired or occur. More often than not this is the situation in context of litigation settlements.

#### A. Code §2519.

1. A surviving spouse disposing of the income interest in a QTIP trust in exchange for the receipt of consideration is treated similarly under Code §2519 as a transfer by gift. See the above discussion at II.A. Code §2519 again treats the spouse as if he or she made a taxable

gift of the remainder interest. Treas. Regs. §25.2519-1(g), Ex. 2. *See also Estate of Novotny v. Commissioner*, 93 T.C. 12 (1989) and Rev.Rul. 98-8, 1998-1 CB 541. The Code §2519 taxable gift is computed in the same manner discussed above for a gift disposition.

2. Therefore, if the spouse disposes of all or part of her income interest in settlement of litigation in exchange for consideration, Code §2519 will still apply.
3. Note that if the surviving spouse is also entitled to distribution of principal on an ascertainable standard or otherwise, the Code §2519 consequences can be mitigated somewhat by having a separate sale or exchange of the spouse's rights to principal. Such separate sale should reduce the value of the principal that is deemed to be gifted under Code §2519. See PLR 200027001 (Rulings #4 and #7). As noted in PLR 20027001, the uniform basis rules under Code §1001(e) applies only to income interests in trust, and not rights to principal, so the surviving spouse's basis in trust principal will not be disregarded in computing gain or loss for the spouse on such a sale of principal rights.

#### B. Other Tax Consequences - Remainder Interest Segment.

1. 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 Code §2207A(b) for the taxes relating to the Code §2519 transfer when the income interest is disposed of for consideration, but chooses not to enforce it. See II.B.1 above. Query, however, whether a gift will apply if the waiver of the right of recovery is not gratuitous but is conducted for valuable consideration as part of the settlement of litigation.

#### C. Other Tax Consequences - Income Interest Sold Segment

1. Taxable Gifts. Regarding the income interest that is sold, no separate taxable gift for transferring that interest occurs if the spouse receives consideration equal to the fair market value of the income interest. Treas. Regs. §25.2519-1(g), Ex. (2). If the consideration is less than the value, a taxable gift for the difference occurs.
2. Gain or Loss.
  - a. Under Code §1001, the selling surviving spouse realizes gain or loss on the disposition of the income interest. However, since the surviving spouse will have 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, Code §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.
  - b. More specifically, Code §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 pursuant to Code §1014 (relating to the basis of property acquired from a decedent), Code §1015 (relating to the basis of property acquired by gift or by a transfer in trust), or Code §1041 shall be disregarded. *See also* Treas. Regs. §§1.1014-5(a)(1), 1.1014-5(b), 1.1014-5(c), Examples, §1.1001-1(f)(1). An income interest in a trust is a “term interest” for this purpose. Code §1001(e)(2)(C). However, if all of the income interest and all remainder interests are simultaneously sold, Code §1001(e)(3) instead allows for the allocation of basis to the income interest under the uniform basis rules.

- (1) *Example.* Assume under the preceding example that Joan sold the 1/2 interest in the income interest to Nancy for its fair market value (\$200,000) instead of having transferred it as a wholly gratuitous gift. Under Code §2519, the same \$600,000 gift occurs. However, since Joan was paid for the income interest, no separate taxable gift of the income interest occurs. However, Joan will recognize taxable gain equal to the full value of the 1/2 of the income interest sold, or \$200,000. The same inclusion of 1/2 of the trust property at Joan’s death occurs under Code §2036.
- c. 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 Code §1001 provisions. That is, what at 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. Treas.Reg. §1.1001-1(a). *Evans v. Commissioner*, 30 T.C. 798 (1958) (exchange of income interest in a trust for an annuity was a realization event). Private Letter Ruling 200231011, August 2, 2002 (relating to gain from a trust modification). However, *see also Silverstein v. United States*, 419 F.2d 999 (7th Cir. 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 v. Commissioner*, 499 U.S. 554 (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 results in *Silverstein*.

#### D. Other Tax Consequences - Income Interest Retained Segment

1. Code §2036. If only a portion of the income interest was sold so that the surviving spouse also retains a partial income interest, Code §2036 inclusion of that retained portion should also apply at the death of the surviving spouse. Treas. Regs. §25.2519-1(a). However, see the contrary arguments of some commentators discussed at Section II.D.1.a above.
2. Code §2044. Code §2044 inclusion will not occur at that time due to the prior application of Code §2519. Code §2044(b)(2).

#### IV. Distributions of Principal to Spouse.

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

##### A. By Exercise of Existing Power to Appoint Principal to Spouse.

1. If the surviving spouse or a third party has a power to appoint principal of the trust to the spouse, the Treasury Regulations under Code §2519 explicitly provide that such an appointment does not trigger Code §2519 - even if the spouse subsequently disposes of the distributed property. Treas. Regs. §25.2519-1(e).
2. This presumably also covers discretionary or mandatory principal distributions required by the trust instrument, such as under HEMS distribution standards.

##### B. By Commutation of the Trust.

1. The surviving spouse and the remaindermen may 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.
2. If analyzed from the perspective of the purpose of Code §2519 - 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, Code §2519 should apply since only a portion of the QTIP trust is passing into the hands of the surviving spouse. Consistent with that perspective, both the case law and the IRS apply Code §2519 to the commutation of a QTIP trust. *Estate of Novotny v. Commissioner*, 93 T.C. 12 (1989); Rev.Rul. 98-8. The authorities hold that a commutation is the same as a sale by the surviving spouse of his or her income interest, which as discussed above results in a taxable gift under Code §2519.
  - a. Some practitioners (especially nontax practitioners), when first confronted with a potential gift tax on the commutation of a QTIP, understandably can't find a "gift" and thus question this result. Their principal argument is that the spouse only received her actuarial interest in the trust, so there should be no gift element. Of course, from a tax policy standpoint, the "gift" aspect is required to protect the transfer tax base. That is, when the QTIP was created, a marital deduction was allowed for the entire amount funded. The transfer tax base was protected (except in regard to consumption of principal during the surviving spouse's lifetime) by Code §2044, which includes the full QTIP assets in the taxable estate of the surviving spouse at his or her later death for estate tax purposes. If Code §2519 does not apply to a commutation, taxpayers could

easily avoid the 100% inclusion of Code §2044 at the death of the surviving spouse since at death the surviving spouse would only own what is left from the receipt of the actuarial interest of the surviving spouse - the value of the remainder interest would have passed totally free of transfer tax to the remaindermen. Thus, Code §2519 operates at the time of commutation to tax the value of the remainder.

- b. 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. PLR 200013015, April 3, 2000.
3. Commuting a QTIP trust should not result in a taxable gift under Code §2511 as to a transfer of the surviving spouse's income interest, since the surviving spouse is receiving full value for that interest.
4. *Example.* Under the same QTIP trust facts above, 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 Code §2519.
5. In Private Letter Ruling 200723014, the IRS sanctioned a method of reducing the impact of Code §2519 on a *partial* commutation.
  - a. In that private 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, Code §2519 only applied to the Trust B assets, and not the Trust A assets. Thus, 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 Code §2519. The IRS similarly ruled in Private Letter Ruling 199926019, under which a QTIP trust was divided into two trusts. The surviving spouse's nonqualified disclaimer of her income interest in one of the two trusts was determined not to create a Code §2519 taxable gift as to the other QTIP trust. Taxpayers should be cautious in relying on these rulings since Code §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 arises.
6. A commutation may also be characterized as a taxable sale by the surviving spouse of his or her income interest. *See* PLR 200127023, July 15, 2001, wherein the IRS treated the commutation of a charitable remainder trust as a taxable exchange by the individual lead interest holder, generating gain under Code §1001. If so characterized, the surviving spouse will have gain under Code §1001 equal to the full amount received by him or her, since as noted above, no basis will be allocated to the life interest under the uniform basis rules and Code §1001(e).

- a. It is the author's opinion that such taxable sale treatment should not apply, or if it does, that the zero basis result under the uniform basis rules should not apply.<sup>2</sup>

V. Disposition of Remainder Interests - By Gift.

Another method of dealing with beneficiary conflicts is to remove one or more remaindermen from the trust.

- A. Gift transfers of remainder interests generally should not have any Code §2519 impact, since the surviving spouse is not disposing of his or her income interest.
  1. If the remaindermen gift their remainder interests to the surviving spouse, this should still not trigger a gift under Code §2519. If all of the remainder interests are paid to the surviving spouse, under the doctrine of merger the trust should terminate in favor of the surviving spouse. In this case, the surviving spouse has not made any disposition. Further, from a policy standpoint, the spouse is including all of the QTIP assets into his or her transfer tax base under the doctrine of merger. The remaindermen themselves, however, are making a taxable gift to the spouse, unless the transfer is for other consideration (in which case gain or loss may result). In PLR 199908033, remaindermen making such a transfer argued the value of the gift is \$0 because the transferred assets were already included in the spouse's transfer tax basis pursuant to Code §§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 their transfer was subject to gift tax.
  2. As a practical matter, a useful rule of thumb in determining when Code §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<sup>3</sup> - 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 Code §2519 gift. Transfers of remainder interests (other than by sale to the surviving spouse, as discussed below), and distributions of principal to the surviving spouse without a concomitant distribution of trust assets to remaindermen (watching out for indirect distributions via direct payments from the trust,

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<sup>2</sup> If all of the income interest and all remainder interests are simultaneously sold, Code §1001(e)(3) instead allows for the allocation of basis to the income interest under the uniform basis rules. Presumably, if a commutation involves a "sale" of the income interest, then it is a sale of all of the income and remainder interests, thus allowing Code §1001(e)(3) to operate.

<sup>3</sup> An alternate formulation is to ask whether any assets that would be used to produce income for the spouse (including assets outside of the trust) have ended up in the hands of anyone other than the spouse.

the spouse, or other related parties), do not trigger such a gift under the rule of thumb. The rule of thumb will also flush out potentially hidden Code §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.

- B. The remaindermen who make the gift will be making taxable gifts, to the extent of the value of the remainder interests. This is so, even if the recipient is the surviving spouse, as discussed above. PLR 199908033, March 1, 1999. Actuarial computations as to the value of the remainder interest can be problematic if the spouse's life interest allows for withdrawal or distributions of principal to the spouse. Treas. Regs. §1.7520-3(b)(1)(ii) ; Treas. Regs. §20.7520-3(b)(2)(v), Examples 4 & 5.

#### VI. Disposition of Remainder Interests - By Sale/For Consideration.

- A. A sale of a remainder interest to anyone other than the surviving spouse should not have any Code §2519 impact, since the surviving spouse is not disposing of her income interest.
- B. The seller will recognize gain or loss on the sale under Code §1001, to the extent that the sale proceeds exceeds his or her adjusted basis in the remainder.
  - 1. The adjusted basis of the remainder equals the portion of the adjusted uniform basis assignable to the portion of the remainder being sold. Treas. Regs. §1.1014-5(a)(1). 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. Treas. Regs. §1.1014-5(a)(1). 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. Treas. Regs. §1.1014-5(a)(1). 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. Treas. Regs. §1.1014-5(a)(3). The factors are published in Treas. Regs. §20.2031-7, and Treas. Regs. §20.2031-7A for property received from decedents dying before May 1, 1999.
- C. If the purchaser of the remainder interest is the surviving spouse, under Rev.Rul. 98-8 it is the position of the IRS that a Code §2519 gift (or Code §§2511 and 2512 gift) is triggered. Rev.Rul. 98-8, PLR 199936036.
  - 1. 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 only with 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.

- a. The policy here is once again the protection of the transfer tax base. Before the purchase, if the surviving spouse dies, 100% of the QTIP will be included in the gross estate of the surviving spouse. If the surviving spouse purchases the remainder interest, the spouse's net assets increase by the actuarial value of the income interest of the trust - the spouse receives 100% of the assets upon merger/termination of the trust, but has to pay out the remainder value from other assets, and thus increases his or her directly owned assets only by the value of the income interest. Absent the application of Code §2519, the value of the remainder portion of the QTIP trust would be transferred to the remaindermen free of estate or gift tax.
  - b. In Rev. Rul 98-8, the IRS anticipated an argument that no taxable gift occurs under Code §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 Code §2044, and that in analogous situations, courts have recognized that the 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. The validity of the ruling has not gone unchallenged by commentators. *See* Lipoff, Lawrence M., *Purchase of QTIP Remainder - Revisiting Purchases of Remainder Interests in QTIP Trusts*, 27 Est. Plan. 114 (March/April 2000).
2. The amount of the taxable gift is the greater of (a) the value of the remainder interest gift under Code §2519, and (b) the value of the property or cash transferred to the holder of the remainder interest (under Code §§2511 and 2512). This result occurs whether the purchase is for cash or for a promissory note.
  3. 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 provides 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 Code §2519 likely applies, since only a partial transfer of an income interest by a spouse triggers a full taxable gift under Code §2519. If a partial termination does not occur under state law, the amount paid to the remaindermen could still constitute a gift under Code §§2511 and 2512.
- D. 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, or the IRS may be able to recast the purchase as a purchase by the surviving spouse.

## VII. 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 usage of state law amendment of trust statutes, a modification of a trust to allow for or accommodate such a transfer may occur long after the QTIP trust was set up and a marital deduction allowed for.

### A. Code §2519.

1. The policy of Code §2519 suggests that such a distribution will trigger a taxable gift under Code §2519. The purpose of Code §2519 is to backstop Code §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.
2. The IRS interprets the word “disposition” under Code §2519 broadly. In Rev.Rul. 98-8, it held 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 portion. Therefore, a strong argument can be made that Code §2519 will apply to a principal distribution to a remainderman.

## VIII. Conversion of QTIP Income Interest to Unitrust Interest

- A. 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.
- B. 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 Code §2056(b)(7)(B)(ii)(I) that all of the income of the trust be distributed to the spouse. Treas. Reg. §§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.
- C. Therefore, 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 hold a conversion of a regular income trust to a unitrust does not trigger Code §1001 gain or loss to any of the beneficiaries, will not be considered to shift any beneficial interest in the trust and do not cause a trust to lose its status as exempt from the

GST tax. Private Letter Rulings 200752026, 200752027, and 200752028, December 28, 2007.

- D. Thus, such a conversion should likely not cause a taxable gift under Code §2519 - however, since there is no direct authority on this issue a private letter ruling would be helpful to confirm this treatment.

## **DISCUSSION QUESTIONS**

### **QUESTION 1 - DOES §2519 APPLY?**

Under Dad's prior estate planning documents, Mom would have received an income interest in a \$10 million QTIP. Under newer documents, the QTIP is to be funded with \$20 million. Stepdaughter sues Mom, asserting undue influence over the newer documents. In settlement of the litigation, Mom and Stepdaughter agree to fund the QTIP with \$15 million.

### **QUESTION 2 - BASIC APPLICATION OF §2519**

Mom is the surviving spouse of Dad, and has an income only interest in a QTIP trust that was established for her when Dad died. Dad's daughter, Stepdaughter is the sole remainder beneficiary of the QTIP trust. The trust assets are \$10 million in securities. Using actuarial tables, based on Mom's age her life interest is worth \$4 million.

Mom transfers 1/2 of her income interest to Stepdaughter.

### **QUESTION 3 - PORTION OF QTIP EXCHANGED FOR VALUABLE CONSIDERATION**

Mom is the surviving spouse of Dad, and has an income only interest in a QTIP trust that was established for her when Dad died. Dad's daughter, Stepdaughter is the sole remainder beneficiary of the QTIP trust. The trust assets are \$10 million in securities. Using actuarial tables, based on Mom's age her life interest is worth \$4 million.

Stepdaughter asserts that Mom forged a deed on Dad's house, transferring the ownership to Mom shortly before Dad's death.

Mom transfers 1/2 of her income interest in the QTIP trust to Stepdaughter in settlement of litigation over the forged deed.

### **QUESTION 4 - COMMUTATION**

Mom is the surviving spouse of Dad, and has an income only interest in a QTIP trust that was established for her when Dad died. Dad's daughter, Stepdaughter is the sole remainder beneficiary of the QTIP trust. The trust assets are \$10 million in securities. Using actuarial tables, based on Mom's age her life interest is worth \$4 million.

Mom and Stepdaughter are fighting over the investments of the QTIP trust. Mom is seeking greater

investment in income producing assets, and Stepdaughter wants more principal growth.

To end the dispute, Mom and Stepdaughter have agreed to commute the trust. Mom will receive \$4 million of the trust assets for her life estate, and Stepdaughter will receive \$6 million (now, instead of at Mom's death).

#### QUESTION 5 - GIFT OF REMAINDER INTEREST

Mom is the surviving spouse of Dad, and has an income only interest in a QTIP trust that was established for her when Dad died. Dad's daughter, Stepdaughter is the sole remainder beneficiary of the QTIP trust. The trust assets are \$10 million in securities. Using actuarial tables, based on Mom's age her life interest is worth \$4 million.

Stepdaughter transfers her remainder interest to Mom.

#### QUESTION 6 - SALE OF REMAINDER INTEREST

Mom is the surviving spouse of Dad, and has an income only interest in a QTIP trust that was established for her when Dad died. Dad's daughter, Stepdaughter is the sole remainder beneficiary of the QTIP trust. The trust assets are \$10 million in securities. Using actuarial tables, based on Mom's age her life interest is worth \$4 million.

Mom and Stepdaughter are fighting over the investments of the QTIP trust. Mom is seeking greater investment in income producing assets, and Stepdaughter wants more principal growth.

In settlement of the litigation, Mom agrees to purchase from her own separate funds  $\frac{1}{2}$  of the remainder from Stepdaughter for \$3 million.

#### QUESTION 7 - PRINCIPAL DISTRIBUTION TO REMAINDERMAN

Mom is the surviving spouse of Dad, and has an income only interest in a QTIP trust that was established for her when Dad died. Dad's daughter, Stepdaughter is the sole remainder beneficiary of the QTIP trust. The trust assets are \$10 million in securities. Using actuarial tables, based on Mom's age her life interest is worth \$4 million.

Mom and Stepdaughter are fighting over the investments of the QTIP trust. Mom is seeking greater investment in income producing assets, and Stepdaughter wants more principal growth.

In settlement of the litigation, Mom agrees to a distribution from the trust of \$3 million to Stepdaughter.

## 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>		No §2044 gross estate inclusion at death of SS.	§2036 inclusion of portion of trust at SS's death, if SS retains a portion of the income interest.
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 portion of income 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>	§1001 gain to SS - no basis allowed to SS on gain computation.	No §2044 gross estate inclusion at death of SS.	§2036 inclusion of portion of trust at SS's death, if SS retains a portion of the income interest.

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.