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The Qualified Terminable Interest Rule: An Overview

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THE QUALIFIED TERMINABLE INTEREST RULE: AN OVERVIEW

INTRODUCTION

A widower with a substantial accumulation of wealth remarries late in life. He wants to assure that when he dies his second wife will enjoy an income interest for life without control of his property and that the property will eventually pass to the children of his first marriage. The obvious way to accomplish this is to will the spouse a life estate, with remainder to his children. Prior to the Economic Recovery Tax Act of 1981 (ERTA),[1] such a plan resulted in forfeiture of the estate tax marital deduction for the property since the deduction was not available for terminable interests. However, ERTA provides relief for this well-to-do remarried testator. The amended marital deduction section introduces a deduction for "qualified terminable interests."

This paper provides an overview of ERTA's "qualified terminable interest rule."[2] The background of the marital deduction is presented and the terminable interest rule is discussed. A summary of the background of the qualified terminable interest rule, the new exception to the terminable interest rule, is explored. In order to provide an adequate understanding of the purposes and requirements of this new exception, legislative hearings and proposals initiated prior to the Tax Reform Act of 1976 are relied on. Finally, the consequences of utilizing the qualified terminable interest rule are examined at length, analyzing possible statutory problems and appropriate circumstances for use of the rule.

THE MARITAL DEDUCTION

The marital deduction originally was enacted[3] to equalize the treatment of property transfers between married persons living in community property states and common law states.[4] In community property jurisdictions any property acquired during marriage, except that acquired by gift or inheritance to one spouse, is generally owned one-half by each spouse by operation of state law.[5] On the death of either spouse, therefore, only one-half of the community property would be included in the decedent spouse's gross estate for federal estate tax purposes,[6] regardless of which spouse had actually earned or acquired

1. The Economic Recovery Tax Act of 1981 § 403(d)(1), Pub. L. No. 92-84 (Aug. 13, 1981).
2. I.R.C. § 2056(b)(7) (West Supp. 1982).
3. Revenue Act of 1948, ch. 168, §§ 351, 361, 62 Stat. 110, 116.
4. *See* Northeastern Pa. Nat'l Bank & Trust v. United States, 387 U.S. 213, 219 (1967); United States v. Stapf, 375 U.S. 118 (1963).
5. *See, e.g.*, R.C.W.A. 26.10.010 & .020. The issue of whether specific assets are separate or community is dependent on state law. *See generally* 4 J. RABKIN & M. JOHNSON, FEDERAL INCOME GIFT AND ESTATE TAXATION § 52.07 (1982).
6. I.R.C. § 2033 (1976) defines the gross estate to include the value of all property in which the decedent has an interest at the time of death. In a community property state a

such property. In contrast, in a common law jurisdiction all property owned by an individual at death, which included all property that individual had earned or acquired during marriage, is included in the decedent spouse's gross estate.[7]

In 1942 Congress attempted to alleviate the unequal treatment between common law and community property states arising under the federal transfer taxes by requiring that all community property be included in the first-to-die spouse's estate, except property that the executor could trace to compensation for personal services rendered by the surviving spouse.[8] The 1942 provisions failed to equalize federal transfer tax bases in community property and common law jurisdictions, and additionally created a tracing problem by requiring the identity of the economic source of particular assets to establish that they were earned by personal services of the surviving spouse.[9]

In recommending repeal of the 1942 amendments, the Senate Finance Committee noted that when a husband in a common law state has bequeathed to his wife a life estate, with remainder to his children, at his death the whole estate is taxed, but at his wife's death there is no tax on the cessation of her life estate.[10] In a community property state, the husband may not transfer his wife's interest in community property by will. If he bequeaths his one-half interest in the community property to his wife for life with remainder to his children, the entire community property may be included in his gross estate, and at his wife's death, her half of the community property will be included in her estate as well.[11] The common law couple is subject only to one transfer tax, whereas the community property couple pays two transfer taxes, one on an estate of equal size and one on an estate half the size of that passing in the common law state.[12]

The Revenue Act of 1948 repealed the 1942 amendment and substituted a marital deduction for property passing to the surviving spouse.[13] The deduction was limited to fifty percent of the adjusted gross estate.[14] The marital deduction was not available for a decedent's interest in community property because after the repeal of the 1942 amendments the surviving spouse received one-half of the community property tax-free.[15] The marital deduction was available for noncommunity property in community property states.[16] By providing

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decedent has an interest in only one-half of the community property as defined under state law.

7. *Id.*

8. Revenue Act of 1942, ch. 619, 56 Stat. 802, 941.

9. *See* S. REP. No. 1013, 80th Cong., 2d Sess. 18, *reprinted in* 1948 U.S. CODE CONG. & AD. NEWS 1168, 1189 [hereinafter cited as S. REP.].

10. *Id.* at 18.

11. *Id.*

12. *Id.*

13. Revenue Act of 1948, ch. 168, §§ 351, 361, 62 Stat. 110, 116.

14. The 1948 Act also provided for a gift tax marital deduction equal to one-half the value of the interest transferred. *Id.* § 361.

15. *See id.*

16. *See* Revenue Act of 1948, ch. 361, 62 Stat. 110, 117. I.R.C. § 2056(c)(2)(B) (1976) provided a special rule for the computation of the adjusted gross estate for community

a marital deduction for property passing to the surviving spouse in a common law state, geographical equality for federal estate tax purposes seemed to be achieved.[17] Although the amount of the marital deduction allowance has changed,[18] interests passing to the surviving spouse which may not qualify for the deduction have essentially remained unchanged since 1948 and are embodied under section 2056. Before discussing ERTA's new qualified terminable interest rule, it is necessary to analyze those interests passing to the surviving spouse that were deductible or nondeductible under section 2056 prior to the enactment of the qualified terminable interest rule.

Section 2056(a) authorizes a deduction from the gross estate for any property passing to the surviving spouse, but only to the extent such property is includable in the decedent's gross estate.[19] In order for a property interest to qualify for the marital deduction the regulations require that the decedent be survived by the spouse, the property interest must pass from the decedent to the spouse and the property interest must be a deductible interest.[20] Property generally is considered as "passing" to the surviving spouse if the surviving spouse becomes the owner of the property by bequest, devise, inheritance, or right of survivorship.[21] The regulations also provide exceptions to the marital deduction, specifically excepting a terminable interest.[22] This exception to deductibility is complex and must be discussed before analyzing the new qualified terminable interest rule.

The Terminable Interest Rule

The terminable interest rule of section 2056(b)(1) provides that no deduction shall be allowed for an interest in property that has passed to a surviving spouse which will terminate or fail upon the lapse of time or the occurrence or nonoccurrence of a specific event if the property then passes to another person who acquires the interest from the decedent for less than adequate consideration.[23] For example, if the decedent leaves *S*, the surviving spouse, Greenacre for life with remainder to *C*, their child, such an interest is

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property estates which consisted partly of community property and partly of noncommunity property.

17. *See* S. REP., *supra* note 9, at 18-19.

18. The Tax Reform Act of 1976 expanded the marital deduction by providing for a minimum $250,000 marital deduction allowance. Tax Reform Act of 1976, Pub. L. No. 94-455, §§ 2002(a), (d)(1), 90 Stat. 1520, 1890 (1976), 1976-3 C.B. 366, *amending* I.R.C. § 2056(c)(4). ERTA, §403(d)(1), now provides for an unlimited marital deduction. See *infra* text accompanying notes 62-67 for discussion.

19. I.R.C. §2056(a) (1976).

20. Treas. Reg. § 20.2056(a)-1(b) (1958).

21. I.R.C. § 2056(c) (West Supp. 1982) provides a very broad definition of the term "passing." For a detailed discussion of this requirement, see R. STEPHENS, G. MAXFIELD & S. LIND, FEDERAL ESTATE AND GIFT TAXATION ¶ 5.06[3] (1978) [hereinafter cited as R. STEPHENS].

22. I.R.C. § 2056(c) (West Supp. 1982) states in part an interest is deductible unless "1. the interest is not included in the decedent's gross estate as provided in section 2056(a); or . . . . 4. the interest is a terminable interest." *See also* Treas. Reg. § 20.2056(a)-2(b) (1958); R. STEPHENS, *supra* note 21, ¶ 5.06[8].

23. I.R.C. § 2056(b)(1) (1976).

a nondeductible terminable interest because *S*'s interest will end at death whereupon *C* will enjoy Greenacre by virtue of the termination of *S*'s interest.

The terminable interest rule serves two purposes: preventing decedents in common law jurisdictions from gaining an advantage over decedents in community property jurisdictions and ensuring property which qualifies for the marital deduction in the estate of the first-to-die spouse will be subject to federal transfer taxes upon an inter vivos or testamentary disposition of such property by the surviving spouse.[24] A decedent in a common law jurisdiction could take advantage of the marital deduction by giving the surviving spouse a life estate in property but for the terminable interest rule. Upon the death of the surviving spouse the property would pass to the remainderman without additional federal transfer taxes because no part of the property would be includable in the surviving spouse's gross estate.[25] Such a result is not possible in a community property state because each individual owns outright one-half of the community property and neither can unilaterally affect the other's interest. At least one half of the community property therefore will be subject to federal transfer taxes in each spouse's federal transfer tax history. In effect, the terminable interest rule ensures that for a decedent in a common law jurisdiction to take advantage of the marital deduction, the property must be passed outright or the equivalent of outright ownership must be given to the surviving spouse. The rule creates qualitative and quantitative parity between common law and community property jurisdictions.[26] Qualitative parity is achieved because the ownership interest of the surviving spouse in a common law jurisdiction will be similar to the ownership interest of a spouse in community property states. Quantitative parity exists because when the surviving spouse makes an inter vivos or testamentary transfer it will be subject to federal transfer taxes as will a transfer of a spouse's one-half interest in community property.[27]

Whether the surviving spouse has a terminable interest must be determined at the date of the decedent's death.[28] For example, a widow's allowance has been held to be a nondeductible interest when the right to the allowance was contingent upon a final support order or the surviving spouse's remarriage.[29] Property rights obtained through forced heir statutes may be nondeductible interests if under state law the surviving spouse receives only a life interest in such property.[30]

In order to designate a property interest a nondeductible terminable

24. S. REP., *supra* note 9, at 67.

25. *See* I.R.C. § 2033 (1976). *See supra* note 6.

26. *See* Note, *Section 2056(b)(5): An "Apparent" or "Real" Exception to the Terminable Interest Rule?*, 51 NOTRE DAME LAW. 803, 806-07 (1976).

27. The qualitative parity sought by the terminable interest rule has to some extent been eroded by the enactment of the new qualified terminable interest exception to the terminable interest rule. See *infra* text accompanying notes 75-129.

28. Jackson v. United States, 376 U.S. 503, 508 (1964). *See also* R. STEPHENS, *supra* note 21, ¶ 5.06[8][b].

29. 376 U.S. at 506-07.

30. R. STEPHENS, *supra* note 21, ¶ 5.06[8][b]. If, however, the surviving spouse may elect a lump sum in lieu of dower, the lump sum qualifies for the marital deduction. *Id.*

interest, someone else must possess or enjoy the property after the termination of the surviving spouse's interest.[31] For example, if Greenacre is bequeathed to surviving spouse *S* for twenty years and then remainder to child *C*, *C* has a remainder interest which will be enjoyed after the cessation of the spouse's estate for a term of years. Therefore, *S*'s interest is a nondeductible terminable interest. If, however, the decedent owns a patent which has a limited life and leaves this patent to the surviving spouse, that interest in the patent is a deductible interest even though the patent itself is a terminable interest because the decedent did not provide for someone else to enjoy the property after the cessation of the surviving spouse's interest.[32] Finally, the interest which the third party enjoys in the property must pass gratuitously from the decedent spouse.[33] If child *C*, in the example above, pays decedent for the remainder interest, the life interest passing to *S* qualifies for the marital deduction because no interest passes to *C* for less than adequate consideration.

Exceptions to the Terminable Interest Rule

The existing statutory exceptions to the terminable interest rule must be explored to understand the new qualified terminable interest rule. Prior to January 1, 1982,[34] section 2056(b) contained only four exceptions to the terminable interest rule: the six month survival and common disaster,[35] the life estate coupled with power of appointment in the surviving spouse,[36] and the life insurance or annuity payments coupled with a power of appointment.[37]

The first two exceptions are in section 2056(b)(3). A property interest passing to the surviving spouse will not be considered a terminable interest simply because it will terminate or fail upon either that spouse's death within six months of the decedent's death, or the deaths of both spouses in a common disaster.[38] If neither event occurs,[39] the surviving spouse's interest will not be considered terminable merely because the will provided for such a possibility. Were it not for this exception to the terminable interest rule, these common testamentary provisions could render any bequest to the surviving spouse a nondeductible terminable interest.[40] The regulations clearly indicate, however, that section 2056(b)(3) applies only if failure of the surviving spouse's interest occurs in a common disaster or within six months of the decedent's death.[41] If it is possible that the spouse's interest may fail after a six month

31. I.R.C. § 2056(b)(1)(B) (1976).
32. R. STEPHENS, *supra* note 21, ¶ 5.06[8][c].
33. I.R.C. § 2056(b)(1)(A) (1976).
34. *See id.* §§ 2056(b)(7), (8) (West 1982) is effective for estates of decedents dying after December 31, 1981.
35. *Id.* § 2056(b)(3) (1976).
36. *Id.* § 2056(b)(5).
37. *Id.* § 2056(b)(6).
38. *Id.* § 2056(b)(3)(A).
39. *Id.* § 2056(b)(3)(B).
40. R. STEPHENS, *supra* note 21, ¶ 5.06[9][a].
41. Treas. Reg. § 20.2056(b)-3(b) (1958) provides: "[I]f the condition (unless it relates to death as a result of a common disaster) is one which may occur either within the six month period or thereafter, the exception provided in § 2056(b)(3) will not apply." *Id.*

period, the exception will not apply.[42]

The third exception, found in section 2056(b)(5), provides that when a surviving spouse is given a life interest the entire underlying property will qualify for the marital deduction if certain statutory requirements are met.[43] The requirements of section 2056(b)(5) are complex and have resulted in much litigation. Both the Internal Revenue Service and the courts have narrowly interpreted congressional intent, forcing those taking advantage of the exception to jump through statutory hoops in a rigidly mechanistic manner.[44] With the exception of one, the section 2056(b) (5) requirements are identical to the requirements of the new qualified terminable interest exception to the terminable interest rule.[45] Discussion of these requirements, therefore, is postponed for consideration in the context of the new qualified terminable interest rule.[46]

The one changed requirement is that the surviving spouse must have the power to appoint the entire interest of the specific portion to either himself or his estate.[47] The legislative history of section 2056(b)(5) indicates the purpose of this section is to require that the surviving spouse be given the equivalent of outright ownership before the terminable interest is deductible.[48] Section 2056(b)(5) therefore continues to provide the same qualitative and quantitative parity sought by the enactment of the terminable interest rule.[49] The surviving spouse will have the equivalent of outright ownership and the property will be included in his estate. The determinative factor is whether the surviving spouse's power is broad enough to make him virtual owner of the property. Both the governing instrument and state law aid in determining whether the requisite power exists.[50] For example, when the surviving spouse

42. *Id.* § 20.2056(b)-3(d) ex. 4.

43. I.R.C. § 2056(b)(5). To qualify for the marital deduction, the life interest must fulfill the following requirements:

> 1. the surviving spouse must be entitled for life to all of the income from the entire interest or a specific portion of the entire interest, or to a specific portion of all the income from the entire interest;
> 2. the income payable to the surviving spouse must be payable annually or at more frequent intervals;
> 3. the surviving spouse must have the power to appoint the entire interest or the specific portion to either herself or her estate;
> 4. the power in the surviving spouse must be exercisable by her alone and (whether exercisable by will or during life) must be exercisable in all events; and
> 5. the entire interest or the specific portion must not be subject to a power in any other person to appoint any part to any person other than the surviving spouse.

44. Jackson v. United States, 376 U.S. 503 (1963) exemplifies the mechanistic manner in which § 2056(b)(5) should be applied by pointing out that "the achievement of the purposes of the marital deduction is dependent to a great degree upon the careful drafting of wills." *Id.* at 511.

45. I.R.C. § 2056(b)(7) (West Supp. 1982).

46. See *infra* text accompanying notes 84-129.

47. I.R.C. § 2056(b)(5) (1976).

48. S. REP., *supra* note 9, at 1.

49. See *supra* text accompanying notes 26-27.

50. Treas. Reg. § 20.2056(b)-5 (1958). *See* R. STEPHENS, *supra* note 21, ¶ 5.06[9][b].

is given the power to consume the trust corpus but exercise of the power is limited to support needs, the section 2056(b)(5) requirement has not been met.[51] This requirement has prompted considerable litigation[52] and was one of the problems sought to be corrected by the new qualified terminable interest exception.[53]

The fourth exception to the terminable interest rule closely parallels the life estate with power of appointment exception.[54] Section 2056(b)(6) provides that an interest in property which consists of life insurance proceeds or payments under an annuity contract and which passes to the surviving spouse will qualify for the marital deduction if specified requirements are met.[55] The surviving spouse must have the power to appoint all or a specific portion of the amounts held by the insurer to himself or his estate.[56] Whether the surviving spouse has the requisite power is again critical. Unlike the life estate with power of appointment exception, however, the new qualified terminable interest exception is unlikely to provide relief from this requirement.

THE QUALIFIED TERMINABLE INTEREST RULE

Prior to the Tax Reform Act of 1976, Congress had before it several recommendations for major estate and gift tax reform.[57] Among the recommendations were the American Law Institute's (A.L.I.) proposals for an unlimited marital deduction and the substitution of a current beneficial enjoyment rule for the terminable interest rule. The beneficial enjoyment rule provided a marital deduction for every transfer resulting in the surviving spouse's current beneficial enjoyment of the property whether the transfer was for the spouse's life or for any lesser period of time.[58] The A.L.I. proposals also provided that

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51. Treas. Reg. § 20.2056(b)-5 (1958). *See also* Estate of Pipe v. Commissioner, 241 F.2d 210 (2d Cir.), *cert. denied*, 335 U.S. 814 (1957), which held that a power to consume was not broad enough to allow the surviving spouse to appoint the corpus to herself as owner and therefore the requirements of § 2056(b)(5) were not met.

52. For a more detailed discussion of this requirement, see R. STEPHENS, *supra* note 21, ¶ 5.06[9][b].

53. See *infra* text accompanying notes 68-69.

54. R. STEPHENS, *supra* note 21, ¶ 5.06[9][b].

55. I.R.C. § 2056(b)(6) (1976) which states in part:

> 1. The proceeds, or a specific portion of the proceeds, must be held by the insurer subject to an agreement either to pay the entire proceeds or a specific portion thereof in installments . . .
>
> 4. The power in the surviving spouse must be exercisable by her alone and (whether exercisable by a will or during life) must be exercisable in all events.

56. *Id.* "5. The amounts or the specific portion of the amounts payable under such contract must not be subject to a power in any other person to appoint any part thereof to any person other than the surviving spouse."

57. The text of the proposals considered by Congress prior to the Tax Reform Act of 1976 may be found in *U.S. Treasury Dep't, Tax Reform Stud. & Proposals: Hearings Before the House Comm. on Ways & Means*, 91st Cong., 1st Sess. (1969).

58. *See* Casner, *American Law Institute Federal Estate and Gift Tax Project*, 22 TAX L. REV. 545, 547 (1967). *See also General Tax Reform: Panel Discussion Before the House Comm. on Ways & Means*, 93d Cong., 1st Sess. (1973) [hereinafter cited as *Tax Reform*].

upon the termination of the surviving spouse's current beneficial enjoyment, whether a life interest or a term interest, the surviving spouse would be treated as making a transfer of the property.[59] A transfer would also be imputed to the surviving spouse if the income interest were disposed of by sale or gift.[60] To avoid an added transfer tax burden, the transfer tax attributable to the remainder interest would be collectable only out of the property producing the income.[61]

Proponents of the beneficial enjoyment rule were generally concerned about the effect of estate and gift taxes on small businesses which might have to be sold upon the owner's death to pay estate taxes.[62] It was argued that instead of preventing unreasonable accumulations of wealth as the estate tax was intended to do, the result was the opposite. The decedent's family was forced to sell the business to large corporations which were never subject to the estate tax because they have perpetual life.[63] In order to prevent such a result, it was argued that the married couple should be viewed as an economic unit, and therefore, spousal transfers should go untaxed.[64] If an unlimited marital deduction was enacted, however, it was feared that the decedent might be tempted to dispose of property unwisely by leaving it all to the surviving spouse.[65] The beneficial enjoyment rule would eliminate such an unwise disposition[66] because it would allow the decedent to provide income for the surviving spouse and simultaneously designate those persons who would enjoy the property upon termination of the spouse's interest. Finally, the rule's proponents indicated that technicalities in drafting a will providing for deductible interests to the spouse would be eliminated by enactment of an unlimited marital deduction and a beneficial enjoyment rule.[67]

Opponents of the proposals argued that a beneficial enjoyment rule would create further complexities of its own.[68] The trade-off involved in using the beneficial enjoyment rule, that the underlying property might be treated as a

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59. *Tax Reform, supra* note 58, at 10.

60. *Id.*

61. *Id.*

62. *Federal Estate & Gift Taxes, Public Hearings & Panel Discussions Before the House Comm. on Ways & Means*, 94th Cong., 2d Sess., pt. 1, at 23 (March, 1976).

63. *Id.*

64. *Id.* at 24.

65. *Id.* at 133, 284.

66. *Id.* at 133-34. Discussion at these hearings before the House Committee on Ways and Means reflected a somewhat hypocritical analysis of viewing the married couple as an economic unit. It was argued that often the wife had contributed equally with the husband to the development of the family business and therefore the married couple should be viewed as an economic unit. Simultaneously, however, it was also feared that the husband, usually the first-to-die spouse, would make an unwise disposition if he surrendered complete control of the business at death to his wife in order to take advantage of the unlimited marital deduction. This feared "unwise disposition" differs from viewing a married couple as an economic unit to which both spouses contribute equally.

67. *Id.*

68. *Federal Estate & Gift Taxes, Statement of the American Bankers Assoc. in Pub. Hearings Before the House Comm. on Ways & Means*, 94th Cong., 2d Sess. 49 (March, 1976) [hereinafter cited as *Bankers*].

transfer of property subject to estate and gift tax liability by the surviving spouse upon testamentary disposition of the interest, caused particular concern.[69] Tax liability would result to the surviving spouse from property over which that spouse had no control.[70] The A.L.I. proposals, however, sought to minimize this result. The proposals provided that only the particular property subject to the surviving spouse's income interest would be used to satisfy the additional tax liability from treating such property as a transfer from the surviving spouse.[71] Opponents also argued that because the rule provided that the decision to qualify property for the marital deduction would be elective, the only way to avoid inclusion of such property in a surviving spouse's estate was for that spouse to disclaim the income interest.[72] Such a result, although unlikely, could also destroy the testator's intent because the decedent would no longer be providing income to the surviving spouse, and the property would not qualify for the marital deduction.[73]

Although not enacted in 1976, the beneficial enjoyment rule and the unlimited marital deduction are now part of the Internal Revenue Code as amended by ERTA.[74] While not identical to the earlier proposals,[75] the congressional purpose in enacting section 2056(b)(7), the qualified terminable interest rule, is an outgrowth of these earlier proposals. The report of the House Ways and Means Committee reflects this purpose in stating the need for liberalization of the limitations preventing transfers of terminable interest from qualifying for the marital deduction.[76] The Committee expressed fear that one's freedom of disposition would be impaired if, as under the current law, "a decedent [were] forced to choose between surrendering control of the entire estate at his death or reducing his tax benefits at his death to insure inheritance to his children."[77] This report further provides that the property subject to terminable interest will be subject to federal transfer taxes either when the surviving spouse makes an inter vivos disposition of the income interest or at the death of the surviving spouse.[78]

ERTA's unlimited marital deduction and the qualified terminable interest rule altered the purpose for which the marital deduction was first enacted in 1948. The emphasis in creating parity between community property and common law jurisdictions has shifted from a quantitative/qualitative approach to a solely quantitative approach.[79] It is no longer necessary to give the sur-

69. *Id.* at 202-03.
70. *Id.* at 203.
71. *See* Casner, *supra* note 58, at 547.
72. *Bankers, supra* note 68, at 203.
73. *Id.*
74. *See* I.R.C. § 2056(b)(7) (West Supp. 1982); ERTA § 403(d)(1).
75. One significant difference is that the "qualified terminable interest rule" will not apply to interests passing to the surviving spouse for a term of years as was initially proposed by A.L.I. See *infra* text accompanying notes 91-104 for a discussion of possible reasons for the change.
76. H.R. REP. No 201, 97th Cong., 1st Sess. 159 (1981) [hereinafter cited as H.R. REP.].
77. *Id.*
78. *Id.*
79. See *supra* text accompanying notes 26-27.

viving spouse the "equivalence of virtual ownership" of the property subject to the qualifying income interest[80] as effected by law in a community property state.[81] Residents of common law states now have the option of taking complete advantage of the marital deduction without giving the surviving spouse outright ownership of the property. This option is not available to residents of community property states except to the extent of the spouse's one-half interest in community property.[82] Quantitatively, however, parity is still achieved since all property qualifying for the marital deduction will be subject to federal transfer taxes either upon an inter vivos disposition of the qualifying income interest or at the surviving spouse's death.[83] This change in emphasis must be kept in mind in the following analysis.

Requirements of the Qualified Terminable Interest Rule

Section 2056(b)(7) adds a fifth exception to the terminable interest rule, providing for an election to have certain life interests in property qualify for the marital deduction.[84] The statute provides that after election, qualified

80. See *supra* text accompanying notes 24-25.

81. See *supra* text accompanying note 25.

82. I.R.C. § 2056(c)(2)(B) (1976) was repealed by ERTA, *supra* note 1, § 403(a)(1)(A). The result is that the decedent's estate now qualifies for the marital deduction to the extent of decedent's one-half interest in the community property.

83. I.R.C. § 2519 & § 2044 (West 1981). See also *supra* text accompanying notes 26-27.

84. I.R.C. § 2056(b)(7) (West Supp. 1982) provides:

(7) Election with respect to life estate for surviving spouse.

(A) In general. In the case of qualified terminable interest property —

(i) for purposes of subsection (a), such property shall be treated as passing to the surviving spouse, and

(ii) for purposes of paragraph (1)(A), no part of such property shall be treated as passing to any person other than the surviving spouse.

(B) Qualified terminable interest property defined — For purposes of this paragraph —

(i) In general — The term "qualified terminable interest property" means property —

(I) which passes from the decedent,

(II) in which the surviving spouse has a qualifying income interest for life, and

(III) to which an election under this paragraph applies.

(ii) Qualifying income interest for life — The surviving spouse has a qualifying income interest for life if—

(I) the surviving spouse is entitled to all the income from the property, payable annually or at more frequent intervals, and

(II) no person has a power to appoint any part of the property to any person other than the surviving spouse.

Subclause (II) shall not apply to a power exercisable only at or after the death of the surviving spouse.

(iii) Property includes interest therein. The term "property" includes an interest in property.

(iv) Specific portion treated as separate property — A specific portion of property shall be treated as separate property.

(v) Election — An election under this paragraph with respect to any property

terminable interest property will be treated as though passing solely to the surviving spouse.[85] Qualified terminable interest property is defined as property passing from the decedent[86] in which the surviving spouse has a qualifying income interest for life and for which an election is made to treat the property as a deductible interest.[87] The heart of the qualified terminable interest rule lies in the definition of a qualifying income interest for life as one which satisfies two criteria: first, "[t]he surviving spouse is entitled to all the income from the property, payable annually or at more frequent intervals" and second, "[n]o person has power to appoint any part of the property to any person other than the surviving spouse."[88]

The First Criterion

The first criterion of a qualified income interest for life is virtually identical to the language of the life interest with power of appointment exception to the terminable interest rule.[89] It is fair to assume that case law, pertinent revenue rulings, and treasury regulations under the life interest exception will apply to this section 2056(b)(7) requirement. In fact, some regulations were made specifically applicable.[90]

To qualify for a section 2056(b)(7) election the interest passing to the surviving spouse must be a life interest.[91] It is clear from the legislative history that an income interest for a term of years will not qualify.[92] For example, if under state law the widow is given an allowance for her support during settlement of her husband's estate and the allowance ceases upon her remarriage, then the allowance is a terminable interest for which no election can be made.[93] The reason for this requirement may be that if the life interest were to end upon the spouse's remarriage or a stated number of years, the

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shall be made by the executor on the return of tax imposed by section 2001. Such an election, once made, shall be irrevocable.

Id. See Id. § 2523(f) for the gift tax counterpart of *id.* § 2056(b)(7).

85. *Id.* § 2056(b)(7)(A). The section makes it clear that in the case of qualified terminable interest property the limitations on deductibility of *id.* § 2056(b)(1) (1976) will not apply.

86. For "passing" requirements, see *id.* § 2056(c) (West Supp. 1982) as redesignated by virtue of the repeal of *id.* § 2056(c) (1976) by ERTA § 403(d)(1)(A).

87. I.R.C. § 2056(b)(7)(B)(i) (West Supp. 1982).

88. *Id.* § 2056(b)(7)(B)(ii).

89. *See supra* note 43 and accompanying text.

90. H.R. REP., *supra* note 76, at 161 *citing* Treas. Reg. § 20.2056(b)-(f) in providing that the bill does not limit qualifying interests to those placed in trust if such an income interest "provides the spouse with rights to income which are sufficient to satisfy the rules applicable to marital deduction trusts under present law." *Id.* There is no regulation numbered § 20.2056(b)-(f); however, Treas. Reg. § 20.2056(b)-5(f) (1958) deals with the "right to income" requirements referred to in the Committee Report.

91. I.R.C. § 2056(b)(7)(B)(ii) (West Supp. 1982).

92. H.R. REP., *supra* note 76, at 161. The report states; "[T]he spouse must be entitled for a period measured solely by the spouse's life to all the income . . . thus, income interest granted for a term of years or life estates subject to termination upon remarriage or the occurrence of a specified event will not qualify . . . ." *Id.*

93. *E.g.*, Jackson v. United States, 376 U.S. 503 (1964).

spouse would be subject to a transfer tax forced by the requirement of the trust and not by a voluntary disposition.[94]

The surviving spouse must be entitled to all the income from the property.[95] This requirement is met if the trust allots the surviving spouse the degree of beneficial enjoyment of the trust property which trust laws accord to a life beneficiary of the trust.[96] Whether the surviving spouse is given the requisite degree of enjoyment will be determined by the decedent's intention under the terms of the will or trust instrument taking into account state law and all the surrounding circumstances.[97] A marital trust providing that the trustees pay at least annually so much of the trust income to the surviving spouse as "in their conclusive discretion" should be expended to accomplish the trust's purpose has been held to fulfill the income requirements of section 2056(b)(5).[98] Since the stated purpose of the trust was to qualify for the marital deduction, the words "conclusive discretion" did not authorize the trustee to withhold income payments.[99]

The decedent may grant the trustee administrative power to allocate items of receipt or expense as long as such provisions provide the surviving spouse with the requisite degree of enjoyment.[100] Such provisions will not deprive the spouse of the requisite degree of enjoyment if under state law reasonable limitations are placed upon these powers.[101] The regulations provide an example in which the trustee is given the power to retain trust assets consisting primarily of unproductive assets but state laws would permit the spouse to require the trustee to convert the property within a reasonable time. This right under state law would provide the surviving spouse with the requisite degree of enjoyment to satisfy the income requirement.[102] If the surviving spouse had no such right under state law, however, the requisite degree of enjoyment would not be present and the qualified terminable interest rule's income requirement would not be met.[103]

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94. *See* I.R.C. § 2519 (West Supp. 1982). *See also* Covey, Surrey & Westfall, *Perspectives on Suggested Revisions in Federal Estate and Gift Taxation,* 112 TR. & EST. 102, 145 (1973). This requirement is a significant departure from earlier A.L.I. proposals for a beneficial enjoyment rule.

95. I.R.C. § 2056(b)(7)(B)(ii)(I) (West Supp. 1982).

96. Treas. Reg. § 20.2056(b)-5(f)(1) (1958).

97. *Id.*

98. Estate of Todd v. Commissioner, 57 T.C. 288 (1971).

99. *Id. See also* Friedman v. United States, 364 F. Supp. 484 (S.D. Ga. 1973) (although the trust instrument had no requirement to distribute all the income to the surviving spouse, the trust was held to qualify for the marital deduction under § 2056(b)(5) (1976) because a Georgia statute provided that if the trust instrument is silent as to frequency of distribution of income, the trustees are required to distribute all the income).

100. Treas. Reg. § 20.2056(b)-5(f)(3) (1958). *See* Rev. Rul. 69-56, 1969-1 C.B. 224 for examples of powers conferred on a trustee which will not destroy the surviving spouse's requisite degree of enjoyment.

101. Treas. Reg. § 20.2056(b)-5(f)(4) (1958).

102. *Id.*

103. *Id.* R. STEPHENS, *supra* note 21, ¶ 5.06[9][b] criticizes this regulation indicating that no "unproductive property rule appears in the statute either expressly or by inference." *Id. But see supra* note 90.

This regulation is of increased importance under the qualified terminable interest election because the surviving spouse has no control over the ultimate disposition of the property. If the trust contained unproductive assets and the spouse had no power of appointment, an election under section 2056(b)(7) would result in the inclusion of the property in the surviving spouse's gross estate without any current enjoyment *or* power to dispose of the property. Such a result is clearly inequitable. Any provision granting the trustee discretion to accumulate income is likewise inequitable and will deprive the spouse of the requisite degree of enjoyment.[104]

To qualify for election, the income must be payable at least annually.[105] This requirement can be satisfied in three ways: by the trust instrument requiring the trustee to distribute the income, by state law requiring such distributions in the absence of a trust provision, or by empowering the surviving spouse either under state law or the trust instrument to require such distribution.[106]

The Second Criterion

The second criterion for a qualified income interest is that no person has a power to appoint any part of the property to any person other than the surviving spouse.[107] The statute makes clear that this requirement does not apply to powers exercisable only upon the death of the surviving spouse.[108] The committee reports indicate that even the spouse may not have power to appoint to anyone else.[109] Therefore, if the spouse is given an income interest for life with the power to invade the corpus for the benefit of the couple's minor children, the second criterion of section 2056(b)(7)(B)(ii) cannot be met and no election will be available to qualify the interest for the marital deduction. This requirement ensures that the surviving spouse will have complete beneficial enjoyment of the property transferred and that the entire property will be taxable in the surviving spouse's estate.[110] Such a result would not occur if an income interest to the surviving spouse for life with a special power to appoint corpus to the children qualified for the marital deduction. Upon an inter vivos exercise of the special power of appointment, the surviving spouse would be subject to no federal gift tax[111] and such an exercise would diminish, if not eliminate, the underlying property subject to federal estate taxes at that spouse's death. Consequently, if the surviving spouse is given a special power of appointment over the property constituting

104. Treas. Reg. § 20.2056(b)-5(f)(7) (1958).
105. Id. § 20.2056(b)-5(f)(8). *See generally* R. STEPHENS, *supra* note 21, ¶ 5.06[9][b].
106. *See* R. STEPHENS, *supra* note 21, ¶ 5.06[9][b].
107. I.R.C. § 2056(b)(7)(B)(ii)(II) (West Supp. 1982). But see *infra* text accompanying notes 110-11 for discussion of where the trustee's power to appoint a specified sum of income or corpus may still result in the surviving spouse being entitled to all the income from a "specific portion" of property.
108. I.R.C. § 2056(b)(7)(B)(ii) (West Supp. 1982).
109. H.R. REP., *supra* note 76, at 161.
110. *Id. See also* I.R.C. § 2044 (West Supp. 1982).
111. I.R.C. § 2514 (1976) applies only to general powers of appointment.

the life income interest, in order to take advantage of the section 2056(b)(7) exception it would be necessary for the surviving spouse to disclaim the special power.[112]

If the trustee is given the power to invade the corpus for the benefit of the surviving spouse, the income interest will qualify for the section 2056(b)(7) election. Any property not consumed will be included in the surviving spouse's taxable gifts or gross estate for federal transfer tax purposes. When the surviving spouse is given a power to invade the corpus for his or her own benefit, the value of the property constituting the income interest will be deductible under section 2056(b)(5), only if the power to invade is considered a general power of appointment exercisable in all events.[113] If the power of the surviving spouse to invade the corpus is not considered a general power of appointment,[114] however, then the income interest will qualify for an election under section 2056(b)(7). In this respect, at least, Congress has removed some of the uncertainty surrounding the applicability of section 2056(b)(5).

The statute, however, has not removed uncertainty in another area. Section 2056(b)(7) provides that a specific portion of property shall be treated as separate property for purpose of election under this section.[115] The statute does not define the term "specific portion." The regulations provide that for purposes of section 2056(b)(5) a partial interest in property will not be treated as a specific portion of property unless the spouse's rights to the income are expressed in a fractional or percentile share.[116] This requirement was rejected by the United States Supreme Court in *Northeastern Pennsylvania Bank & Trust Co. v. United States*.[117] The Court found no such intention in the legislative history.[118] The trust in *Northeastern*, which provided for monthly payments of $300 to the wife, qualified for the marital deduction to the extent of the amount of corpus necessary to provide that income based upon a reasonable rate of return under reasonable investment conditions.[119]

In *Gelb v. Commissioner*[120] a trust which provided income payable to the wife for life but allowed the trustee to invade the corpus in an amount not to exceed $5,000 per year for the benefit of a minor child qualified for the

112. *See id.* § 2518(c)(2) (West Supp. 1982).

113. See *supra* text accompanying notes 49-50.

114. *Id.* See generally R. STEPHENS, *supra* note 21, ¶ 5.06[9][b] for a discussion of whether a power to consume is equivalent to a general power of appointment.

115. I.R.C. § 2056(b)(7)(B)(iv) (West Supp. 1982).

116. Treas. Reg. § 20.2056(b)-5(c) (1958).

117. 387 U.S. 213 (1967).

118. *Id.* at 220-21. The Court stated:

> There is no indication in the legislative history . . . that Congress . . . in using the words "all the income from a specific portion" in the statute, or the equivalent words "a right to income . . . over . . . an undivided part" in the committee reports . . . intended that the deduction afforded would be defeated merely because the "specific portion" or the "undivided part" was not expressed by the testator in terms of a "fractional or percentile share" of the whole corpus.

119. *Id.* at 224-25.

120. 298 F.2d 544 (2d Cir. 1962).

marital deduction.[121] The Court ruled the wife was entitled to all the income from a "specific portion" of the trust, computed by applying actuarial factors to determine the maximum which could be paid to the daughter and deducting that amount from the corpus.[122] The difference between these two amounts was held to be a "specific portion."[123]

Northeastern and *Gelb* would apply to the qualified terminable interest setting since the reference to a "specific portion" in section 2056(b)(7) is virtually identical to the reference in section 2056(b)(5). Assuming these decisions are viable under section 2056(b)(7),[124] it is necessary to re-evaluate the requirement that no person has a power to appoint any part of the property. A section 2056(b)(7) election will not be defeated as long as the trustee's power to appoint corpus to a third party is limited to a specific sum. Any trust which provides that the spouse will receive a specific sum of income will qualify for an election under section 2056(b)(7), by the *Northeastern* rationale, to the extent of corpus necessary to produce that income. If, however, the trustee's power to invade the corpus were unlimited, there would be no election under section 2056(b)(7) since the surviving spouse's beneficial enjoyment could be completely curtailed by an appointment of the entire corpus.

It is unclear whether a power held by a trustee to accumulate a specific amount of income for the benefit of someone other than the surviving spouse will meet the specific portion requirement. Although the *Northeastern* and *Gelb* rationale would appear to apply and the specific portion from which the spouse is entitled to the income could be computed actuarially in much the same way, the United States Treasury appears to have taken an opposite view. The Treasury has ruled that when the trustee was directed to accumulate $40,000 in income from the *entire* trust for the education expenses of his grandchildren, the surviving spouse had no right to any determinable portion of the corpus.[125] This ruling appears inconsistent with *Northeastern*. It seems inevitable that the definition of a "specific portion" will continue to be a problem under the qualified terminable interest rule.

It may be helpful to gain some perspective on the relationship between the new qualified terminable interest exception to the terminable interest rule and the other four exceptions discussed previously. The qualified terminable interest rule has little, if any, impact on the six month survival or common disaster exceptions.[126] Section 2056(b)(7) by definition only applies to qualified terminable interest property, therefore, there is little overlap between the two exceptions. However, an interesting situation arises when the surviving spouse is left property outright provided the spouse survives the decedent for nine months; if this does not occur, the interest passes to the children. Section

121. *Id.* at 550.

122. *Id.*

123. *Id.*

124. The committee reports make no reference to Treas. Reg. § 20.2056(b)-5(c) (1958), which defines the term "specific portion." Since Congress has not specifically approved this regulation or made it applicable to I.R.C. § 2056(b)(7) (West Supp. 1982), *Northeastern* is still the final word on the definition of specific portion.

125. Rev. Rul. 77-444, 1977-2 C.B. 341.

126. I.R.C. § 2056(b)(3) (1976). See *supra* text accompanying notes 34-56.

2056(b)(3) provides no relief from such a provision, and therefore, the interest passing to the surviving spouse will be considered a terminable interest. The surviving spouse arguably has a qualifying income interest since the only way that the spouse may be divested of this interest is by death and no person has a power to appoint the property to any other person. The Treasury, however, will need to clarify the interrelationship between these exceptions to the terminable interest rule.

The new qualified terminable interest exception will probably not have any impact on the life insurance with power of appointment exception.[127] If interest on the insurance proceeds is to be paid to the surviving spouse for life, and at the death of the surviving spouse the principal is to be paid to son, the surviving spouse arguably has a qualified terminable interest which qualifies for the section 2056(b)(7) election. However, if the insurance contract provided installment payments to the surviving spouse for life and remainder to son, it is unclear whether the surviving spouse has the requisite beneficial enjoyment of the property. Because of this uncertainty section 2056(b)(6) was enacted. It appears therefore that in the absence of any reference in the new qualified terminable interest rule to insurance proceeds or payments under an annuity contract, the qualified terminable interest rule will not apply to such payments. Again, Treasury regulations and case law will have to clarify any relation between these two exceptions.

Finally, as noted previously, the life estate with power of appointment exception[128] to the terminable interest rule has been greatly expanded under the new qualified terminable interest rule. It is no longer necessary to give the surviving spouse the equivalent of outright ownership of the property under section 2056(b)(5) by giving the spouse a power of appointment over the property. In this respect Congress has removed some of the uncertainty surrounding the determination of whether the surviving spouse had the requisite power.[129]

Consequences of a Section 2056(b)(7) Election

Once it has been determined that property has passed from the decedent and that the surviving spouse has a qualifying income interest, to qualify for the marital deduction the executor of the estate must make an election on the estate tax return.[130] Since such an election is irrevocable, the consequences of such an election must be carefully considered.

Consequences to the Surviving Spouse

If an election is made to treat the income interest passing to the surviving spouse as qualified terminable interest property, the immediate effect on the decedent's estate is that the full value of the property in which the surviving

127. *Id.* § 2056(b)(6).

128. *Id.* § 2056(b)(5).

129. See *supra* text accompanying notes 43-53.

130. I.R.C. § 6075 (1976) requires the estate tax return to be filed nine months after the decedent's date of death.

spouse has a "qualifying income interest may be deducted."[131] At least as far as the decedent is concerned, it is as though the property passed outright to the surviving spouse. From the surviving spouse's perspective, it is clear that no such outright ownership exists. The spouse has only an income interest with no power to direct who shall receive the underlying property either during life or at death unless the spouse is given the power to invade the corpus for his or her own benefit.[132]

Section 2044 makes clear that the surviving spouse is also treated as though receiving the property outright for the imposition of federal transfer taxes.[133] This section provides that, unless the surviving spouse has made an inter vivos disposition of the income interest, the gross estate of the spouse at death will include the value of any property in which the now deceased spouse had a qualifying income interest and for which an election was made to treat the property as qualified terminable interest property.[134] The "gross estate" is defined generally as the value of property to the extent that an individual has an interest in such property at the time of death.[135] Since section 2044 mandates the inclusion of qualified terminable interest property in the surviving spouse's gross estate for federal estate tax purposes, the terminable interest is treated as ownership of the entire corpus.

Section 2519, the gift tax counterpart of section 2044, indicates that for federal gift tax purposes, the surviving spouse will also be treated as the outright owner of the qualified terminable interest property.[136] Section 2519 provides that when the surviving spouse makes a lifetime disposition of the

131. I.R.C. § 2056(b)(7)(A) (West Supp. 1982).
132. See *supra* text accompanying notes 48-53.
133. I.R.C. § 2044 (West Supp. 1982) provides:

> (a) General rule. The value of the gross estate shall include the value of any property to which this section applies in which the decedent had a qualifying income interest for life.
>
> (b) Property to which this section applies. This section applies to any property if—
>
> (1) a deduction was allowed with respect to the transfer of such property to the decedent—
>
> (A) under section 2056 by reason of subsection (b)(7) thereof, or
>
> (B) under section 2523 by reason of subsection (f) thereof, and
>
> (2) section 2519 (relating to dispositions of certain life estates) did not apply with respect to a disposition by the decedent of part or all of such property.

134. *Id.*
135. *Id.* § 2033 (1976).
136. *Id.* § 2519 (West Supp. 1982) provides:

> (a) General rule. 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 such property.
>
> (b) Property to which this subsection applies. This section applies to any property if a deduction was allowed with respect to the transfer of such property to the donor—
>
> (1) under section 2056 by reason of subsection (b)(7) thereof, or
>
> (2) under section 2523 by reason of subsection (f) thereof.

qualifying income interest, the disposition will be treated as a transfer of the property subject to such income interest, if an election was made to treat the property as qualified terminable interest property when the spouse received the income interest.[137] The legislative history indicates that this section will apply whether the inter vivos disposition is by sale or gift.[138] If the surviving spouse sells the income interest, the entire value of the qualified terminable interest property minus the consideration received upon the sale will be treated as a taxable gift.[139] Section 2519 also seems to provide that if the surviving spouse disposes of only part of the income interest, all the underlying property will be treated as transferred.[140]

Whether "transferred" property refers only to that portion of the qualified terminable interest property necessary to produce the portion of the income interest disposed of is unclear. This would seem consistent with treating the surviving spouse as the outright owner of the corpus. Like any other inter vivos trust, it is the value of the trust corpus which is the taxable gift. Since half of the qualified terminable interest property is necessary to produce half of the income interest, only half of such property should be treated as transferred. A contrary conclusion may lead to inequitable treatment of the remainderman.[141]

Upon an inter vivos disposition of qualifying income interest, it is perhaps best to view the surviving spouse as making two dispositions: one of the income interest to whomever the surviving spouse chooses and one of the remainder interest to a predesignated remainderman who was chosen by the deceased spouse. As with any other donor who establishes a trust, an annual gift tax exclusion is available to the surviving spouse for the transfer of the present income interest but no gift tax exclusion is available for the imputed transfer of the remainder interest, which is a future interest.[142]

This fiction of outright ownership of the qualified terminable interest property in the surviving spouse continues throughout such spouse's transfer tax history. For example, a lifetime disposition of the income interest which is treated as a taxable transfer will be deemed a prior taxable gift for purposes of the gift tax gross-up.[143] If in computing gift tax liability on such a transfer any part of the unified credit[144] is used, the credit so used will not be available to the surviving spouse for future transfers.[145] An inter vivos disposition of the

137. *Id.*

138. H.R. REP., *supra* note 76, at 161.

139. *Id.*

140. I.R.C. § 2519(a) (West Supp. 1982). The statute provides: "Any disposition of all or part of a qualifying income interest in any property to which this section applies (i.e., qualified terminable interest property) shall be treated as a transfer of such property." *Id.*

141. See *infra* text accompanying note 155. *See also* Weis, *New Estate Planning Focus*, 55 J. TAX'N 274, 277 (1981).

142. H.R. REP., *supra* note 76, at 161-62. *See also* I.R.C. § 2503(b) (West 1981).

143. *See* I.R.C. §§ 2502 & 2001 (West Supp. 1982).

144. Under I.R.C. § 2505 (West Supp. 1982) "there shall be allowed as a credit against [gift tax] . . . an amount equal to — (1) $192,800, reduced by (2) the sum of the amounts allowable as a credit to the individual under this section for all preceding calendar periods."

145. *See* H.R. REP., *supra* note 76, at 162.

qualifying income interest within three years of death also will increase the surviving spouse's gross estate by the amount of gift tax paid.[146]

The purpose of sections 2044 and 2519 is to ensure the government will get its tax from the property allowed a full marital deduction resulting from passing a qualifying income interest to the surviving spouse.[147] Therefore, care must be taken in determining whether to make a section 2056(b)(7) election. If the election will subject the property to greater tax consequences in the surviving spouse's estate by virtue of such spouse's gift tax history and/or the value of his or her assets owned outright, no election should be made.

Other Consequences: Section 2207A

Treating the surviving spouse as outright owner of the qualified terminable interest property, even though the surviving spouse has no control over such property, could create a harsh result. The surviving spouse, for example, might be precluded from making an inter vivos disposition of the income interest because it would result in gift tax liability on the value of all underlying property. In an attempt to prevent such a harsh result, section 2207A was enacted.[148] This section provides the surviving spouse or that spouse's estate a right of recovery against the persons receiving the property if the transfer tax liability to the surviving spouse has increased due to the inclusion of the qualified terminable interest property as a taxable transfer.[149] The amount of recovery is the difference between the amount of federal transfer taxes paid because of including such property as a taxable transfer and the amount of transfer tax that would have been payable if such property had not been deemed a taxable transfer.[150] The purpose of section 2207A is to ensure that

146. I.R.C. § 2035(c) (West Supp. 1982).

147. H.R. REP., *supra* note 76, at 161.

148. I.R.C. § 2207A (West Supp. 1982) provides in part:

> (a) Recovery with respect to estate tax.
>
> (1) In general. If any part of the gross estate consists of property the value of which is includable in the gross estate by reason of section 2044 (relating to certain property for which marital deduction was previously allowed), the decedent's estate shall be entitled to recover from the person receiving the property the amount by which —
>
> (A) the total tax under this chapter which has been paid, exceeds
>
> (B) the total tax under this chapter which would have been payable if the value of such property had not been included in the gross estate.
>
> (2) Decedent may otherwise direct by will. Paragraph (1) shall not apply if the decedent otherwise directs by will.
>
> (b) Recovery with respect to gift tax. If for any calendar year tax is paid under chapter 12 with respect to any person by reason of property treated as transferred by such person under section 2519, such person shall be entitled to recover from the person receiving the property the amount by which —
>
> (1) the total tax for such year under chapter 12, exceeds
>
> (2) the total tax which would have been payable under such chapter for such year if the value of such property had not been taken into account for purposes of chapter 12.

149. *Id.*

150. *Id.* § 2207A(a)(1), (b).

neither the surviving spouse nor the spouse's heirs will bear the burden of any additional transfer taxes incurred due to this treatment as outright owner of the qualified terminable interest property.[151] While congressional intent in enacting section 2207A is clear, application of the statute presents some difficulties.

Section 2207A provides a right of recovery against "person(s) receiving the property," but does not define this phrase.[152] Is the recipient the remainderman, or the donee or purchaser of the qualifying income interest upon an inter vivos disposition? When there is an intervening income beneficiary between the life estate of the surviving spouse and the ultimate remainderman, is the recipient such a beneficiary? The statute is unclear; however, the committee reports indicate that the recipients of the property will be those persons who enjoy the property, due to a life estate or a remainder interest, upon the surviving spouse's death.[153] Consequently, the term "recipient" would not include a donee or purchaser of the surviving spouse's qualifying income interest.[154]

This result is illustrated by recalling that the surviving spouse is the "actual" owner of an income interest and the "imputed" owner of a remainder interest. In a transfer of the income interest, the surviving spouse should be treated as any other person who transfers such property by gift or purchase; section 2207A is not necessary to reach an equitable result in federal transfer tax liability. It is only necessary when the spouse becomes liable for additional federal transfer taxes because of the imputed transfer of the remainder interest. This is consistent with a proper construction of the statute. Section 2207A allows a right of recovery equal to the additional transfer tax imposed by including the property as a transfer under sections 2044 and 2519. The only additional tax is that caused by the imputed transfer of the remainder interest. Furthermore, sections 2044 and 2519 apply to qualified terminable interest property, or property in which the surviving spouse has a qualifying income interest. These sections clearly distinguish between the underlying property and the income interest. The section 2207A property recipient is the recipient of the underlying property not the income interest of the spouse.

While the committee reports do not define "person(s) receiving the property" directly, they do provide that if inclusion of the entire property as a taxable transfer, due to a lifetime disposition of the qualifying income interest, uses up all or part of the spouse's unified credit the spouse is not permitted to recover the credit amount from the "remainderman."[155] The comment indicates that section 2207A may not achieve absolute equity for the surviving spouse because of the gross-up for prior taxable gifts and use of such spouse's unified credit, but it also indicates that the recipient is the person who will

151. H.R. REP., *supra* note 76, at 161.
152. I.R.C. § 2207A (West Supp. 1982).
153. H.R. REP., *supra* note 76, at 161.
154. For an opposite conclusion and a discussion of the problems which may result, see Weis, *supra* note 141, at 277.
155. H.R. REP., *supra* note 76, at 162.

enjoy the property upon cessation of the surviving spouse's income interest.[156]

It is unfortunate that the word "remainderman" was not used in the statute for confusion is inevitable.[157] The statute is clear, however, if a distinction is drawn between the recipient of the qualified terminable interest property and the donee or purchaser of the qualifying income interest. Furthermore, "recipient" is broad enough to include an intervening income beneficiary between the surviving spouse's qualifying income interest and the distribution of the trust corpus. For example, the trust instrument might provide income to the spouse *S* for life, and at *S*'s death income to *B* for life, remainder to *C*. *B* is technically not a remainderman, but is definitely a recipient of the property in which the spouse had a qualifying income interest. In this situation, both *B* and *C* would be liable to the surviving spouse or the estate for the excess transfer tax resulting from the inclusion of the property under sections 2519 and 2044 in proportion to the value of their relative interests computed on the basis of actuarial tables.

Section 2207A does not relieve the surviving spouse or the executor of transfer tax liability. As the imputed owner of the qualified terminable interest property they are primarily liable for any transfer taxes imposed on such property.[158] Section 2207A merely provides a right of recovery for such transfer taxes which are paid. The statute also provides that the surviving spouse may direct the executor not to recover such amount from the persons receiving the property.[159] Like any other decedent owning property outright, the surviving spouse may direct which estate assets should satisfy any estate tax liability. If the will does not otherwise provide, section 2207A(a) allows a right of recovery against persons receiving the property.[160] The statute thus requires the additional estate tax incurred by virtue of the inclusion of qualified terminable interest property in the surviving spouse's gross estate will be borne by that property. The committee report indicates this was the purpose of section 2207A.[161] Consistent with the fiction of treating the surviving spouse as outright owner of the qualified terminable interest property, the effect of section 2207A is as if part of the property were sold by the executor to satisfy the additional estate tax liability.

Since the section 2207A right of recovery only carries out the fiction created by section 2056(b)(7), this right of recovery should not be viewed as an additional asset of the estate. It is instead as if the executor sold part of the terminable interest property already includable in the surviving spouse's gross estate[162] in order to satisfy part of the transfer tax liability. The fiction of

156. See *supra* text accompanying notes 141-43.

157. *Id.*

158. I.R.C. § 2002 (1976) imposes liability for the estate tax due on the executor; *id.* § 2502(c) (West Supp. 1982) imposes liability for the gift tax due on the donor.

159. *Id.* § 2207A(a)(2) (West Supp. 1982).

160. *Id.*

161. H.R. REP., *supra* note 76, at 162, states: "The bill also provides apportionment provisions under which the additional estate taxes attributable to the taxation of the qualified terminable interest property (other than the spouse's life estate) are born by that property."

162. *See* I.R.C. § 2044 (West Supp. 1982). See also *supra* text accompanying notes 133-34.

sections 2056(b)(7) and 2207A arguably may be carried even further to create income tax consequences to the estate on the deemed sale by the executor of the qualified terminable interest property. Such a result is prevented, however, due to the stepped-up basis of the qualified terminable interest property upon the surviving spouse's death.[163] The stepped-up basis would prevent any realization of gain on the deemed sale.[164]

Section 2207A(b) provides a right of recovery to the surviving spouse who, as a result of an inter vivos disposition of a qualifying income interest, incurs additional gift tax liability because the entire underlying property is included as a taxable gift under section 2519.[165] The purpose is the same: to ensure that any additional tax incurred by the surviving spouse is borne by that property.[166] The statute does not expressly state that the spouse can elect whether or not to exert this right of recovery. Allowing the spouse to determine those assets that will be used to satisfy the gift tax liability is statutorily consistent with the treatment of the surviving spouse as outright owner of the qualified terminable interest property. The legislative history supports this construction.[167]

The surviving spouse does not actually sell the qualified terminable interest property because that spouse has no control over the remainder interest. Consequently, the result created by section 2207A when the surviving spouse exerts the right of recovery more closely resembles a net gift situation.[168] The remainderman is the imputed donee of the remainder interest and, in effect, is obliged to pay the gift tax on the imputed transfer.[169] If treated as a net gift, the value of the imputed transfer, or remainder interest, would be reduced by the amount of gift tax paid.[170]

The income tax consequences to the surviving spouse are unclear if the right of recovery is exercised under section 2207A and the corresponding

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163. *See* I.R.C. § 1014(a) (1976). See also *infra* text accompanying note 186.

164. *See* I.R.C. § 1014(a) (1976).

165. *Id.* § 2207A(b) (West Supp. 1982).

166. *See supra* note 159.

167. H.R. REP., *supra* note 76, at 162, states:

> Unless the spouse directs otherwise, the spouse (or the spouse's estate) is granted a right to recover the gift tax paid on the remainder interest as a result of a lifetime transfer of the qualifying income interest or the estate tax paid as a result of including such property in the spouse's estate.

168. A net gift occurs when the donor transfers property to a donee on the condition that the donee pay the gift tax due as a result of the gratuitous transfer. *See* Sarah Helen Harrison v. Commissioner, 17 T.C. 1350 (1952), *acq.*, 1952-2 C.B. 2. Although the concept of a net gift generally has arisen out of an agreement between the donor and the donee that the donee will pay the corresponding gift tax, it is the obligation of the donee to pay the gift tax which arises out of the agreement which is crucial to the concept of a net gift. The donor is primarily liable for the payment of the gift tax. I.R.C. § 2502(c) (West Supp. 1982). The binding agreement between the donor and donee, however, gives the donor a right of recovery against the donee if the donee does not not in fact pay the tax. This situation is much like the right of recovery under I.R.C. § 2207A(b). *See Weis, supra* note 141, at 277.

169. Weis, *supra* note 141, at 277.

170. *Cf.* Rev. Rul. 75-72, 1975-1 C.B. 310.

obligation of the recipient of the property is treated as a net gift. *Diedrich v. Commissioner*[171] held that when the amount of gift tax paid by the donee in a net gift situation exceeded the donor's basis in the property being transferred, gain is recognized to the donor.[172] Therefore, if the basis in the qualified terminable interest property is less than the gift tax liability and if the surviving spouse exercises the right of recovery under section 2207A, then that spouse would recognize gain under the *Diedrich* rationale. The propriety of *Diedrich* is beyond the scope of this article, however, it is significant that the surviving spouse making an inter vivos disposition of the qualifying income interest may incur income tax consequences by exercising the right of recovery against the remainderman. If the right of recovery is not exercised, the surviving spouse is treated as any other donor who decides to pay the gift tax out of other assets. The spouse is merely carrying out the fiction created by section 2519 and paying the gift tax for which he or she is primarily liable on the deemed transfer of the qualified terminable interest property.[173]

As previously indicated, section 2207A does not completely mitigate the otherwise harsh result of imputing a transfer of the property to the surviving spouse upon an inter vivos disposition of the qualifying income interest. For purposes of computing the spouse's future transfer tax liability, the property value will constitute a prior taxable gift and the spouse's unified credit will be diminished to the extent it is used to offset transfer taxes on the imputed transfer.[174] If the transfer tax on the imputed transfer is completely offset by use of the surviving spouse's unified credit, there will be no right of recovery under section 2207A against the persons receiving the property. When the surviving spouse has made an inter vivos disposition of qualifying income interest within three years of death, the taxes attributable to such transfer will be included in that spouse's estate under section 2035(c). Because the surviving spouse is deemed to have transferred the qualified terminable interest property, the entire amount of the gift tax paid will be included in the estate regardless of any exercise of the right of recovery. If the section 2207A claim has been made, the surviving spouse's estate will be increased by the amount of such recovery which has not been consumed at the date of death.[175] This result under section 2035(c) is consistent with the treatment of the surviving spouse as the outright owner of the qualified terminable interest property.

The effect on recipients of section 2207A is arguably similar to the treatment of other heirs of the decedent or the surviving spouse since the burden of estate taxes is reflected in the diminished value of the legacy. Section 2207A, however, may additionally afford the surviving spouse an opportunity to force the recipient to sell the remainder interest. For example, if the trust assets consist of rapidly appreciating stock, any lifetime disposition of the qualifying income interest will subject the recipient to liability to the surviving spouse. If the recipient is unable to meet this liability the recipient is forced to sell

171. 643 F.2d 499 (8th Cir. 1981), *cert. granted*, 102 S. Ct. 89 (1981).
172. 643 F.2d at 506.
173. I.R.C. § 2502(c) (West Supp. 1982).
174. *Id.* §§ 2010, 2505.
175. *Id.* § 2033 (1976).

all or part of the remainder interest. This result may be acceptable in the estate tax setting because the time of death is not easily manipulated. The same results in an inter vivos disposition, however, are less acceptable, especially if the trust assets consist of a controlling block of stock. Sale of the remainder interest similarly may be forced if the surviving spouse asserts a section 2207A cause of action against the remainderman who is then forced to sell the interest to meet that liability.

Section 2519 might be read to mean that a disposition of part of the qualifying income interest is treated as a disposition of all the qualified terminable interest property. The surviving spouse therefore might force the remainderman to sell out by disposing of a very small part of income interest.[176] Section 2207A thus appears to present problems both in its application and in its results.

Qualified Terminable Interests and Charitable Remainders

ERTA added a sixth exception to the terminable interest rule. Section 2056(b)(8) provides that when an individual creates a qualified charitable remainder annuity trust[177] or a charitable remainder unitrust[178] and the surviving spouse is the only noncharitable beneficiary, the decedent will receive a charitable deduction for the remainder interest and a marital deduction for the income interest to the spouse.[179] The committee report indicated that when the life estate of the surviving spouse is a qualifying income interest under a section 2056(b)(7) election, a similar result will occur by a slightly different statutory route.[180] If the decedent provides an income interest in the spouse for

176. See *supra* text accompanying notes 140-41.

177. *See* I.R.C. § 664(d)(1) (West Supp. 1982) (defines charitable remainder annuity trust to require annual payments of a sum certain).

178. *See id.* § 664(d)(2) (defines charitable remainder unitrust to require annual payments based on a fixed percentage of the corpus).

179. *Id.* § 2056(b)(8)(A) provides in part: "(A) In general. If the surviving spouse of the decedent is the only noncharitable beneficiary of a qualified charitable remainder trust, paragraph (1) shall not apply to any interest in such trust which passes or has passed from the decedent to such surviving spouse. Noncharitable beneficiary is defined as "any beneficiary of the qualified charitable remainder trust other than an organization described in section 170(c)," *id.* § 2056(b)(8)(B)(i), and qualified charitable remainder trust is defined as "a charitable remainder annuity trust or charitable remainder unitrust (described in section 664)." *Id.* § 2056(b)(8)(B)(ii).

180. H.R. REP., *supra* note 76, at 162 n.4. The report explains that:

> The general rules applicable to qualifying income interests may provide similar treatment where a decedent provides an income interest in the spouse for her life and a remainder interest to charity. If the life estate is a qualifying income interest, the entire property will, pursuant to the executor's election, be considered as passing to the spouse. Therefore, the entire value of the property will be eligible for the marital deduction and no transfer tax will be imposed. Upon the spouse's death, the property will be included in the spouse's estate but, because the spouse's life estate terminates at death, any property passing outright to charity may qualify for the charitable deduction.

Id.

life and a remainder interest to charity, the entire property may be considered as passing to the spouse pursuant to the executor's election.[181] The entire value of the property will be eligible for the marital deduction without transfer tax liability.[182]

The property will be included in the spouse's estate at death, but because the life estate terminates at death, any property passing outright to charity may qualify for the charitable deduction.[183] This clearly indicates that in the qualified terminable interest situation there is no requirement that a charitable remainder unitrust or annuity trust be created.[184] This is consistent with the statutory construction of sections 2056(b)(7) and 2044. The transfer of the qualified terminable interest property to the charitable organization is imputed to the surviving spouse and the value of such property is included in the surviving spouse's gross estate under section 2044. The charitable organization in most instances will receive the property outright upon the death of the surviving spouse, therefore there is no need for the requirements of a charitable remainder annuity or unitrust to be met. Because the property is treated as passing outright from the surviving spouse, the spouse's estate will receive the charitable deduction as though the charitable organization were not receiving a remainder interest.

If, however, there is an intervening income beneficiary the requirements pertaining to charitable remainders would apply. For example, if the trust instrument provides, "income to spouse for life, then to daughter for life, remainder to the University of Florida," the full value of the property would qualify for the marital deduction. There would be no charitable deduction to the estate of the surviving spouse, however, since the property does not pass outright to the University of Florida. The surviving spouse is treated as making the transfer of an income interest to daughter and a remainder interest to charity, but the remainder to charity must qualify as a charitable remainder unitrust or annuity trust for estate tax purposes. The surviving spouse's estate will, however, have a right to recover the taxes paid due to the imputed transfer of the income interest and remainder interest from both recipients, daughter and University of Florida.

When the surviving spouse makes an inter vivos disposition of the qualifying income interest, the remainder to charity will not qualify for a gift tax deduction under section 2522. Again it is as though the spouse were making two transfers: one a transfer of an income interest for life and the other a transfer of the remainder interest in the qualified terminable interest property to a charity. The gift of the remainder interest to charity must meet the section 2522(c)(2) requirement that the remainder be a charitable remainder unitrust or annuity trust. Denial of a charitable deduction upon an inter vivos disposition of the qualifying income is consistent with treating the surviving spouse as outright owner of the qualified terminable interest property. Any other result might completely circumvent the purpose of the section 2522(c)(2)

181. *Id.*
182. *Id.*
183. *Id.*
184. *See* I.R.C. §§ 2055(e) & 2522(c) (1976).

requirements.[185] Therefore, whenever the remainder interest is left outright to charity, there is incentive to avoid an inter vivos disposition of the qualifying income interest. In such event the estate of the surviving spouse will receive a charitable deduction for the full value of the qualified terminable interest property.

The Basis of Qualified Terminable Interest Property

Because the surviving spouse is treated as the outright owner of the qualified terminable interest property because of a section 2056(b)(7) election and there is inclusion of the property in the gross estate, at death the qualified terminable interest property is treated as "passing" from the surviving spouse. The recipient of such property therefore should receive a stepped-up basis equal to the fair market value of the property at the date of the surviving spouse's death. Section 1014(a) states the basis of property received by testamentary disposition is the fair market value of the property at decedent's death.[186]

It is clear that qualified terminable interest property receives a stepped-up basis at the death of the first-to-die spouse because one requirement of section 2056(b)(7) is that the property "pass from the decedent to the surviving spouse."[187] Both the surviving spouse and the remainderman will have a basis equal to the property's fair market value at the date of decedent's death. The surviving spouse is treated thereafter as the owner of such property for federal transfer tax purposes, and at that spouse's death, the qualified terminable interest property is treated as passing outright from the surviving spouse to the remainderman. For purposes of computing the basis under section 1014, the remainderman is the person to whom the property has passed from the decedent's spouse and as such, the remainderman should receive a stepped-up basis again upon that spouse's death.

Congress did not address the determination of basis of qualified terminable interest property, however, this construction of sections 1014 and 2044 is consistent with the treatment of the spouse as the outright owner of the property. As in the charitable deduction area, for purposes of section 1014, the surviving spouse is treated as making an outright transfer of property to the remainderman.

ERTA did not amend section 1014(b) to define "property acquired from the decedent as including property in which the surviving spouse has a qualifying income interest." Existing section 1014(b)(9), however, reaches this result.[188] This section requires that the property be acquired from the decedent

185. "Restrictions are established for the deduction of charity bequests . . . in an effort to avoid serious question whether something close to the assumed value of the interest left to charity will actually reach the charitable recipient." R. Stephens, *supra* note 21, ¶ 5.05[8][a].

186. I.R.C. § 1014(a) (1976).

187. *Id.* § 2056(b)(7)(B)(i) (West Supp. 1982).

188. *Id.* 1014(b)(9) (1976) provides "property acquired from the decedent by reason of death, form of ownership, or other conditions (including property acquired through the

by reason of death and be includable in decedent's gross estate.[189] Because the remainderman acquires the property by reason of the death of the surviving spouse and the property is included in the spouse's gross estate under section 2044, the qualified terminable interest property clearly constitutes "property acquired from the decedent" and the basis rule of section 1014 applies.

This is advantageous to the remainderman as long as the surviving spouse does not make an inter vivos disposition of the property. If the spouse does make an inter vivos disposition of the income interest, however, the remainderman's basis will be the same as before such disposition. Both the spouse and the remainderman have a stepped-up basis equal to the date of death value of the property acquired from the decedent spouse computed under the uniform basis rules.[190] If the surviving spouse disposes of the qualifying income interest, this disposition is treated as a transfer of the remainder interest.[191] Furthermore, section 1015 provides that the basis of the property acquired by gift will be the same as the basis of the property in the hands of the donor.[192] Under the uniform basis rules both the surviving spouse and the remainderman have a section 1014 basis before an inter vivos disposition by the surviving spouse. Under section 1015 the remainderman takes the surviving spouse's basis as though the remainder interest were transferred by gift, therefore the remainderman's portion of the basis under the uniform basis rules will still be computed upon the fair market value of the property at the date of death of the first-to-die spouse.[193] The basis to the remainderman should be increased, however, by the amount of any gift tax paid which is attributable to the net appreciation in the gift.[194]

CONCLUSION

As opponents to the qualified terminable interest rule predicted, treating the spouse as outright owner of property in which he or she has only an income interest has created problems of its own. While the immediate results for the first-to-die spouse seem beneficial, the long range results for the surviving spouse need to be considered carefully, for what Congress gives it also takes away. In the qualified terminable interest setting, Congress gives under section 2056(b)(7), takes away under sections 2044 and 2519 and then attempts to give back again by virtue of section 2207A. It is this give, take, and give-back-again situation which creates difficulty and requires careful analysis before an election under section 2056(b)(7) is made.

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exercise or non-exercise of a power of appointment)", shall be considered property passing from the decedent for purposes of subsection (a). *Id.*

189. *Id.*

190. *Id.* § 1014. *See also* Treas. Reg. § 1.1014-4 (1960) for explanation and treatment of uniform basis rules.

191. I.R.C. § 2519 (1976).

192. *Id.* § 1015(a).

193. *Id.*

194. *Id.* § 1015(d)(6).