Office of Chief Counsel
Internal Revenue Service

memorandum

CC:SB:3:NAS:1:TL-N-3596-01
EFHolman Id.# [redacted]

ASSESSMENT STATUTE EXPIRATION DATE:
[redacted]

date:

to: Compliance Policy, Technical Support Section Manager
Attn: Amanda Mynatt - MDP 12

from: Associate Area Counsel
(Small Business/Self-Employed - Area 3)

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subject: **Review of Proposed Statutory Notice of Deficiency**

[redacted]

SSN: [redacted]
Tax: Estate
Date of Death: [redacted]
S/L: [redacted]

Pursuant to your request, we have reviewed the draft statutory notice of deficiency that you propose to issue to the above-referenced executor. It is our opinion that the proposed notice is legally sufficient to apprize this taxpayer of the proposed adjustments. After the suggested changes are made, we recommend that the notice be issued. **Note that the notice must be issued prior to** [redacted].

Assessment Statue of Limitations and Last Known Address

[redacted] (hereinafter, "the decedent") died on [redacted]. This is the date of death reported on page one of the estate tax return, and this date of death is confirmed by an original death certificate attached to the Estate Tax Return Form 706. The due date of the return, [redacted] months following the date of death, was [redacted]. No extension for filing the return was obtained. However, the return was not executed by the executor until [redacted]. The return was hand-delivered to the Little Rock Internal Revenue Service office on that date, and "[redacted]" was hand written by Service personnel on the front of the return. **As a result, the three-year assessment period allowed by I.R.C. § 6501(a) does not expire until** [redacted].

The draft notice reflects the address that was set forth on the income tax return for the executor. Final regulations under I.R.C. § 6212(b) that became effective on January 12, 2001, require that the Service's record of addresses be compared with the National Change of Address ("NCOA") database utilized by the United States Postal Service. A review of the weekly updates of the NCOA by checking the "FASTchek" system of the Post Office is required. Unless review of this source indicates a change of address for the executor, we recommend that the "[redacted]" address be treated as the executor's "last known address" for the purpose of issuing this notice.

We recommend the following adjustments be made to the proposed notice. First, we recommend a change to the signature block on page one of the notice. This also impacts the signature block on the transmittal letter to the attorney for the estate. Your review group is not a part of Area 8 Compliance, i.e., does not report to Bruce Thomas, Field Director of Compliance Area 8. Your group reports to Tom Franke, Compliance Policy Technical Support Manager for Area 8. Delegation Order SB/SE 4.8 gives Mr. Franke authority to sign statutory notices of deficiency. His name, as opposed to Mr. Thomas' name, should be used.

Second, as noted above, the return, though reflecting zero tax due, was late-filed. Because our notice reflects a deficiency, the notice should also assert the failure-to-file penalty pursuant to I.R.C. § 6651(a)(1). The return was [redacted] days late. Therefore, a penalty in the amount of 5% should be applied against the deficiency ultimately determined. (See I.R.C. § 6651(a)(1)).

Third, the adjustment amounts reflected on the calculation sheet and the Explanation of Adjustments page must be revised. The executor took a marital deduction for the eight items that were reported on Schedule M. You did not object to the first two items, because they passed to the spouse by operation of law (i.e., they represented life insurance policies that named the spouse as beneficiary). The seventh item represented the value of the decedent's personal property after reduction for secured debt for which the personalty was collateral. This personalty was treated by the Estate Tax Attorney (hereinafter, "ETA") as passing to the marital trust. Because the ETA determined that the marital trust did not qualify for the marital deduction, the $[redacted] of personal property deducted as item 7 on Schedule M was disallowed, along with items 3 through 6 and 8. In addition, the ETA increased the value of the non-deductible, personal property by $[redacted], i.e., by the value she assigned to growing crops that had been omitted from the return's Schedule F.

As discussed below, the proposed notice's increase to Schedule F and, to the extent of the Schedule M personalty adjustment, the notice's reduction of the Schedule M marital deduction must be eliminated.

Review of the file by the undersigned and the ETA confirmed that the marital trust assets consisted of the items listed on the Schedule A attached to the [redacted] trust document, along with property transferred to the trust by the decedent and his spouse prior to the decedent's death. Schedule A of the trust only reflects an amount of $[redacted] cash. Significantly, while the Probate Court acknowledged that much real property had been transferred to the trust by the decedent and his spouse prior to the decedent's death, the Court ruled that the decedent's personal property had never been transferred to the trust. The Court further ruled that this personal property passed according to the decedent's will. The ETA does not dispute that, according to the terms of the decedent's will, all of the decedent's personal property passed to the surviving spouse.

Therefore, though the total of Schedule F should be increased by the $[redacted] value of the growing crops, that adjustment is offset by an increase to the allowable marital deduction in the same amount. We recommend that the Schedule F adjustment merely be removed from the calculation sheet and the Explanation of Adjustments. In addition, the $[redacted] adjustment to the marital deduction appearing at paragraph (b) on the calculation sheet and the Explanation of Adjustments page must be reduced by $[redacted] (i.e., by the amount of item 7 on Schedule M), because the decedent's personalty passed directly to the surviving spouse and qualifies for the marital deduction pursuant to I.R.C. § 2056(a).

Note that item 8 on Schedule M for which a deduction was taken in the amount of $[redacted] represented the life insurance proceeds included in the gross estate at item 1 on Schedule D. Though the life Insurance Statement provided by the insurance company (Form 712) reflects the beneficiary of the proceeds as being the estate of the decedent (which would not qualify for the marital deduction), the proceeds are described on the return's Schedule M as having passed according to the terms of the revocable trust. The ETA was comfortable that these proceeds passed to the spouse's marital trust and that the marital deduction for these proceeds should be attacked only on the basis of whether the marital trust qualified for the marital deduction.

We recommend that the wording of item (b) on the Explanation of Adjustments page be revised to read, "It is determined that the gross estate should not be reduced by the $_____ reported as the total value for the property described at items 3 through 6 and 8 of Schedule M of the federal estate tax return. The interest of the decedent's surviving spouse in these assets represents a non-deductible, terminable interest pursuant to I.R.C. § 2056(b) to which none of the exceptions of I.R.C. § 2056(b) (including I.R.C. § 2056(b)(5) and § 2056(b)(7)) apply. Accordingly, the taxable estate is increased by $_____."

We believe that the reference to additional state death tax credit at paragraph (c) on the Explanation of Adjustments page should be removed. Sufficient notice of this available credit is given at line 14 on the calculation page.

Marital Trust Fails to Qualify for Marital Deduction

The decedent and his surviving spouse, [redacted], the executor, created a joint revocable trust on [redacted]. This was the same day that the will was executed, and both the will and the trust were finalized with the apparent knowledge that the decedent was dying with colon and lung cancer. (The decedent died within 30 days of the execution of the will and the trust.) The trust reflects only $[redacted] cash as the assets of the trust on the day the trust was executed. However, as discussed above, substantial amounts of real estate were transferred to the trust after it was executed and prior to the decedent's death. Both the decedent and the surviving spouse were trustees of the trust, as well as being the trust's beneficiaries. Upon the death of the first trustor/trustee to die, the trust was to be divided into a marital trust and a non-marital trust. The marital trust provisions are set forth at Section 8 of the trust agreement.

According to the last paragraph of 8.A of the trust agreement, no principal encroachment rights that are available during the surviving spouse's life survive his/her remarriage or cohabitation. According to paragraph 8.B.2, the same is true for the power of appointment available at the surviving spouse's death. Section 15 of the originally created trust is specifically made applicable to the marital trust at paragraph 8.D.

Section 15 clearly provides the trustee with discretion to accumulate income produced by any trust in the event the trustee determines that a trust beneficiary has become disabled. Section 15 appears to require the trustee to add accumulated income to "such beneficiary's principal". However, this reference obviously applies to the separate shares of the original, revocable trust. (See Section 4.) When Section 15 is applied to the marital trust (as required by paragraph 8.D), the "addition to principal" phrase can only refer to an addition to the principal of the marital trust. Because the surviving spouse does not possess a general power of appointment over the marital trust principal "in all events" (e.g., remarriage), and because the principal passes at her death to the trusts of [redacted] and [redacted] (see trust paragraphs 8.B.2 and 10.B.1 and 2), this increase to the marital trust principal cannot indirectly cause all of the income to pass to the surviving spouse.

The ETA concluded that, despite the power of appointment given to the surviving spouse in the marital trust assets, the trust did not qualify for the marital deduction as an exception to the terminable interest rules found at I.R.C. § 2056(b)(5). Not only did the agreement itself characterize this power of appointment as a "special power of appointment" (see paragraph 8.B.2), but even this limited power was not available to the spouse in the event of her remarriage or cohabitation. Therefore, the "in all events" requirement for a general power of appointment in I.R.C. § 2056(b)(5) could not be met.

Because the marital trust was subjected to the terms of Section 15 at paragraph 8.D, the ETA concluded that the marital trust could not qualify for the I.R.C. § 2056(b)(7) exception as a "Qualified Terminable Interest Property" (hereinafter, "QTIP") trust. Due to the application of Section 15, the spouse does not have a right to all of the marital trust's income in the event of her disability. Any trust interest to which Section 15 applies must yield to separate trust terms in the event the trustee determines that the beneficiary has become disabled due to "advanced age, illness, or other cause when he or she becomes entitled to any distribution". As discussed above, the trustee (who, in the event of the surviving spouse's disability, would be her son, according to paragraphs 8.C.2 and 20.A) is authorized to accumulate income during the surviving spouse's disability. The only principal that could be increased thereby would be the principal of the marital trust, which neither passes to the surviving spouse's estate at her death nor is subject to her general power of appointment.

We believe the logic of Estate of Walsh v. Commissioner, 110 T.C. 393 (1998) applies to this trust. Thus, despite the speculative chance of the surviving spouse becoming incapacitated, her failure to possess a right to all of the income of the marital trust in that event defeats the terminable interest exception of I.R.C. § 2056(b)(7).

We also conclude that the facts of this case prevent the marital deduction from being "saved" for the marital trust by Treasury Regulations §§ 20.2056(b)-5(f)(6) or -5(f)(8) (i.e., this spouse cannot claim a right to "all income" through a right to take the entire principal with accumulated income by encroachment or appointment). The ETA's position appears to be consistent with the Service's position upheld by the Tax Court in Estate of Ellingson v. Commissioner, 96 T.C. 760 (1991). That ruling was reversed by the Ninth Circuit Court of Appeals at 964 F.2d 959 (9th Cir. 1992). However, this trust does not have the Ellingson trust language, "in the spouse's best interests" to limit the trustee's income accumulation discretion. The trust language in this case and all other factors are almost identical to those considered in PLR 9645006. In that ruling, Chief Counsel's National Office determined that the marital trust did not qualify for the marital deduction pursuant to I.R.C. § 2056(b)(7). Therefore, we recommend that the marital trust assets deducted at items 3 through 6 and 8 on Schedule M be disallowed as terminable interests under I.R.C. § 2056(b).

With the changes referenced above, we recommend that the statutory notice be issued. We are returning the proposed notice and the administrative file to you at this time. If you have any questions concerning these matters, feel free to contact the undersigned at (615) 250-5466.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney-client privilege. If disclosure becomes necessary, please contact this office for our views.

ROBERT B. NADLER
Associate Area Counsel
(Small Business/Self-Employed)

By:_____
EDSEL FORD HOLMAN, JR.
Senior Attorney (SBSE)

Attachments:
Proposed statutory notice
Administrative file