

INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

July 12, 2004

Third Party Communication: None
Date of Communication: Not Applicable

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CASE-MIS No.: TAM-113017-04/CC:PSI:B4

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Years Involved:
Date of Conference:

LEGEND:

Husband	=
Wife	=
Trust 1	=
Trust 2	=
State	=
Charity	=
Corporate Trustee	=
Date 1	=
Date 2	=
Date 3	=
Citation 1	=

ISSUES:

1. Whether, under section 2056(b)(5) or section 2056(b)(7) of the Internal Revenue Code, the surviving spouse's interest in Trust 1 qualifies for the marital deduction.
2. Whether, under section 2056(b)(7), the surviving spouse's interest in Trust 2 qualifies for the marital deduction.

CONCLUSIONS:

1. The surviving spouse's interest in Trust 1 qualifies for the marital deduction under section 2056(b)(5).
2. The surviving spouse's interest in Trust 2 does not qualify for the marital deduction under section 2056(b)(7).

FACTS:

Trust 1

On Date 1, Husband and Wife, Trustors, executed Trust 1. Trust 1 was funded with community property. The beneficiaries of Trust 1 are Husband and Wife. The original trustees were Husband, Wife, and Corporate Trustee.

Paragraph 3(a) of Trust 1 provides that the Trustee shall distribute the income and principal of the trust to the Trustors or to such persons and in such amounts as either of the Trustors or their authorized representatives may direct. Any net income not so distributed shall be added to the principal of the trust annually.

Paragraph 3(b) provides that in the event that either Trustor becomes severely ill or incapacitated or otherwise unable to communicate with the Trustee, then the Trustee shall have full discretionary authority to utilize income and principal of the trust for the benefit of Trustors for such purposes as Trustee determines to be in the best interest of Trustors.

Paragraph 4(a) provides that upon the death of either Trustor, the assets comprising the trust shall continue to be held in trust for the benefit of the surviving Trustor under the provisions of Trust 1, except that any power or right given to the Trustors shall be exercisable by the surviving Trustor acting alone.

Paragraph 4(b) provides that when neither Trustor is living, the trust shall terminate, and all assets of the trust shall be delivered by the Trustee to Charity.

Paragraph 10(b) provides that the Trustors shall have the right to amend or revoke the Trust Agreement at any time and from time to time in writing delivered to the Trustee. In addition, Trustors may withdraw all of or part of the assets from the trust at any time. In the event a guardian for either Trustor should be appointed by any court of competent jurisdiction, the trust shall be irrevocable by the guardian and shall not be subject to amendment during the existence of the guardianship.

Paragraph 11 provides that the administration, construction, and validity of the trust shall be controlled by the laws of State.

Trust 2

On Date 1, Husband, as Trustor, executed Trust 2. Trust 2 was funded with Husband's separate property. The beneficiaries of Trust 2 are Husband and Wife. The original trustees were Husband and Corporate Trust. If Husband ceased to be a trustee, Wife was to succeed as co-trustee.

Paragraph 3(a) of Trust 2 provides that the Trustee shall distribute the income and principal of the trust to the Beneficiaries or to such persons and in such amounts as the Trustor or his authorized representatives may direct. Any net income not so distributed shall be added to the principal of the trust annually.

Paragraph 3(b) provides that in the event that Trustor becomes severely ill or incapacitated or otherwise unable to communicate with the Trustee, then the Trustee shall have full discretionary authority to utilize income and principal of the trust for the benefit of the Beneficiaries for such purposes as Trustee determines to be in the best interest of the Beneficiaries.

Paragraph 4(a) states "upon the death of either Beneficiary, the assets comprising the trust shall continue to be held in trust for the benefit of the surviving Beneficiary under the provisions hereof."

Paragraph 4(b) provides that when neither Beneficiary is living, the trust shall terminate, and all assets of the trust shall be delivered by the Trustee to Charity.

Paragraph 11 provides that the administration, construction, and validity of the trust shall be controlled by the laws of State.

Husband's Estate Tax Return

On Date 2, Husband died. Husband was a resident of State, a community property state. On Date 3, the executor for Husband's estate filed Form 706, United

States Estate (and Generation-Skipping Transfer) Tax Return. On the Form 706, the executor included 50 percent of the value of Trust 1 and 100 percent of the value of Trust 2 in Husband's gross estate and claimed a marital deduction for those amounts. The executor elected to treat both trusts as qualified terminable interest property (QTIP) for purposes of section 2056(b)(7).

LAW AND ANALYSIS:

Section 2056(a) allows a marital deduction for the value of any interest in property that is included in the gross estate and that passes from the decedent to the decedent's surviving spouse. Section 2056(b)(1) disallows this deduction in the case of a nondeductible terminable interest in property that passes to the surviving spouse; that is, an interest in property that will terminate or fail on the lapse of time, upon the occurrence of an event or contingency, or on the failure of an event or contingency to occur, with respect to which, on termination the property passes to another.

Section 2056(b)(5) provides an exception to the terminable interest rule of section 2056(b)(1) where the surviving spouse receives a life estate and general power of appointment. An interest in property will be eligible for the marital deduction where the interest passes from the decedent to the surviving spouse and the surviving spouse is entitled for life to all the income from the entire interest, or all the income from a specific portion thereof, payable annually or at more frequent intervals, and the surviving spouse possesses a power to appoint the entire interest, or such specific portion, in favor of the surviving spouse or of the estate of the surviving spouse or in favor of either (whether or not in each case the power is exercisable in favor of others). No other person may have the power to appoint any part of the interest to any person other than the surviving spouse. The power in the surviving spouse must be exercisable alone and in all events.

Section 20.2056(b)-5(f)(1) of the Estate Tax Regulations provides that if an interest is transferred in trust, the surviving spouse is "entitled for life to all of the income from the entire interest or a specific portion of the entire interest," for purposes of the requirement that the surviving spouse be entitled for life to all the income, if the effect of the trust is to give her substantially that degree of beneficial enjoyment of the trust property during her life which the principles of the law of trusts accord to a person who is unqualifiedly designated as the life beneficiary of a trust. Such degree of enjoyment is given only if it was the decedent's intention, as manifested by the terms of the trust instrument and the surrounding circumstances, that the trust should produce for the surviving spouse during her life such an income, or that the spouse should have such use of the trust property as is consistent with the value of the trust corpus and with its preservation. The designation of the spouse as sole income beneficiary for life of the entire interest or a specific portion of the entire interest will be sufficient to qualify the trust unless the terms of the trust and the surrounding circumstances considered as a whole evidence an intention to deprive the spouse of the requisite degree of enjoyment. In determining whether a trust evidences that intention, the treatment required or

permitted with respect to individual items must be considered in relation to the entire system provided for the administration of the trust.

Section 20.2056(b)-5(f)(4) provides that provisions granting administrative powers to the trustee will not have the effect of disqualifying an interest passing in trust unless the grant of powers evidences the intention to deprive the surviving spouse of the beneficial enjoyment required by the statute. Such an intention will not be considered to exist if the local courts will impose reasonable limitations upon the exercise of the powers. The trustee's power to apply income or corpus for the benefit of the surviving spouse, if subject to reasonable limitations, will not disqualify the interest passing in trust to the surviving spouse.

Section 20.2056(b)-5(f)(6) provides that, if a trust may be terminated during the life of the surviving spouse, under the spouse's exercise of a power of appointment or by distribution of the corpus to the spouse, the interest passing in trust satisfies the requirement that the spouse be entitled to all the income if the spouse is entitled to the income until the trust terminates, or has the right, exercisable in all events, to have the corpus distributed to the spouse at any time during the spouse's life.

Section 20.2056(b)-5(f)(7) provides that an interest passing in trust fails to satisfy the condition that the spouse be entitled to all the income to the extent that the income is required to be accumulated in whole or in part or may be accumulated in the discretion of any person other than the surviving spouse, to the extent that the consent of any person other than the surviving spouse is required as a condition precedent to distribution of the income, or to the extent that any person other than the surviving spouse has the power to alter the terms of the trust so as to deprive the spouse of the right to the income.

Section 20.2056(b)-5(f)(8) provides that the spouse is "entitled for life" to all of the income if under the terms of the trust the spouse has a right, exercisable at least annually, to require distributions to the spouse of trust income, and otherwise, trust income is to be accumulated and added to corpus.

Section 20.2056(b)-5(g)(1) provides that the spouse's power of appointment does not meet the requisite standards under section 2056(b)(5), unless the power falls within one of the following categories: (1) a power to appoint fully exercisable in the surviving spouse's favor at any time following the decedent's death (as, for example, an unlimited power to invade); (2) a power to appoint exercisable in favor of the surviving spouse's estate; or (3) a combination of the powers described under (1) and (2). Such a power, if exercisable during life, must be fully exercisable during life, or, if exercisable by will, must be fully exercisable irrespective of the time of the surviving spouse's death. However, the condition that the surviving spouse's power must be exercisable in all events is not satisfied unless, irrespective of when the surviving spouse may die, the entire interest or a specific portion of it will, at the time of the surviving spouse's death, be subject to one power or the other.

Section 20.2056(b)-5(g)(3) provides that a power is not considered to be a power exercisable by a surviving spouse alone and in all events if the exercise of the power requires the joinder or consent of any other person. The power is not “exercisable in all events,” if it can be terminated during the life of the surviving spouse by any event other than her complete exercise or release of it.

Section 20.2056(b)-5(g)(5) provides that if the surviving spouse has the requisite power to appoint to herself or her estate, it is immaterial that she also has one or more lesser powers. Thus, if she has an unlimited power of withdrawal, she also may have a limited testamentary power.

Section 2056(b)(7) provides a second exception to the terminable interest rule set forth in section 2056(b)(1). This exception is for “qualified terminable interest property.” This is property (1) which passes from the decedent; (2) in which the surviving spouse has a qualifying income interest for life; and (3) to which an election under section 2056(b)(7)(B)(v) applies.

Section 2056(b)(7)(B)(ii) provides that the surviving spouse has a qualifying income interest for life in the trust property if: (1) the surviving spouse is entitled to all of the income from the property payable annually or at more frequent intervals, and (2) no person has a power to appoint any part of the property to any person other than the surviving spouse, while the surviving spouse is alive.

In addition to the requirement that the surviving spouse be entitled to all of the income from the property, payable annually or at more frequent intervals, section 2056(b)(7)(B)(ii) also requires that no person have a power to appoint any part of the property to any person other than the surviving spouse during the surviving spouse’s lifetime. Under section 20.2056(b)-7(d)(1), the surviving spouse is included within the prohibited class of powerholders.

Section 20.2056(b)-7(d)(2) provides that the principles of section 20.2056(b)-5(f), relating to whether the spouse is entitled for life to all of the income from the entire interest, or a specific portion of the entire interest, apply in determining whether the surviving spouse is entitled for life to all of the income from the property for purposes of section 2056(b)(7).

Section 20.2056(b)-7(d)(6) provides that an income interest in a trust will not fail to constitute a qualifying income interest for life solely because the trustee has a power to distribute principal to or for the benefit of the surviving spouse. The fact that property distributed to a surviving spouse may be transferred by the spouse to another person does not result in a failure to satisfy the requirement of section 2056(b)(7)(B)(ii)(II). However, if the surviving spouse is legally bound to transfer the distributed property to another person without full and adequate consideration in money or money’s worth, the requirement of section 2056(b)(7)(B)(ii)(II) is not satisfied.

Section 20.2056(b)-7(h), Example 4, considers a trust which provides that the surviving spouse is entitled to receive all of the income at least annually. The trustee is given the power to distribute corpus to beneficiaries other than the surviving spouse. The example concludes that the property passing to the trust is not deductible under section 2056(b)(7). In addition, the example states that the trust property would not be deductible under section 2056(b)(7) if the surviving spouse, rather than the trustee, held the power to appoint.

In Rev. Rul. 72-154, 1972-1 C.B. 310, decedent's will established a marital trust for the decedent's spouse pursuant to which the trust net income was paid monthly to his surviving spouse for life with trust corpus to be distributed at the spouse's death as the spouse appoints by will, pursuant to a general power of appointment. During the spouse's lifetime, the trustees may, in their discretion pay to the surviving spouse such sum from the principal as the surviving spouse requests for the purpose of providing for the welfare, maintenance, support or education of decedent's descendants. The ruling considered whether this provision empowered the trustee to appoint any part of the principal to any person other than the surviving spouse. The ruling concludes that the power to invade corpus is a discretionary power of appointment that is exercisable only at the surviving spouse's volition. Therefore, as principal can be diverted to others during the surviving spouse's lifetime only by her initiative, the special power of appointment is not deemed to curtail the spouse's general power of appointment for purposes of section 2056(b)(5). Accordingly, the spouse's discretionary special power to direct distribution of trust corpus to persons other than the spouse did not constitute a power to appoint trust corpus to persons other than the surviving spouse that would disqualify the trust under section 2056(b)(5).

Rev. Rul. 55-518, 1955-2 C.B. 384, involves a situation where, under the terms of a testamentary trust decedent's spouse was granted an inter vivos general power of appointment exercisable during her lifetime. However, the spouse was legally incompetent from the date of the decedent's death until the date of her own death, and therefore, was at all times, legally incapable of exercising the power. The ruling concludes that the transfer in trust qualifies for the marital deduction under section 2056(b)(5), even though the spouse was mentally incompetent at all times after her spouse's death. Although the spouse could not exercise the power because of incompetency, the power continued in existence during the spouse's lifetime.

Rev. Rul. 75-350, 1975-2 C.B. 366, involves facts similar to those presented in to Rev. Rul. 55-518, except that the surviving spouse was granted a testamentary power of appointment. The issue presented is whether the spouse's power is exercisable "in all events" for purposes of section 2056(b)(5), if the spouse was at all times legally foreclosed from executing a will and exercising the power because the spouse was incompetent under state law. The revenue ruling states that the requirement under section 2056(b)(5) that the spouse's power be exercisable "in all events" does not refer to those events that state law has determined to be sufficient to deprive a person of

control of his or her property during a period of physical or mental incompetency. Otherwise, no trust could qualify for the marital deduction under section 2056(b)(5), because the possibility exists that any person could become incompetent. Rather, the practical inability of the spouse to exercise the power due to legal incapacity does not affect qualification under section 2056(b)(5), provided the power continues in existence during the spouse's lifetime. In this regard, the revenue ruling distinguishes Tingley v. Commissioner, 22 T.C. 402 (1954), aff'd sub nom., Starrett v. Commissioner, 223 F.2d 163 (1st Cir. 1955), where the marital deduction was disallowed because, under the terms of the trust, in the event of the spouse's incapacity, the spouse's power of appointment and right to receive all trust income terminated.

Rev. Rul. 85-35, 1985-1 C.B. 328, holds that a marital trust satisfies the requirements of section 2056(b)(5) if under state law the trustee has the power, if the spouse becomes legally disabled, to distribute trust income to a relative or a court-appointed representative for the benefit of the spouse or the trustee may spend trust income directly for the benefit of the spouse. The ruling holds that, under the facts presented, the spouse is "entitled for life" to all trust income because, under state law, even if the spouse became incapacitated, the recipients of the trust income would be required to expend all the income for the benefit of the spouse.

Issue 1

In this case, under Paragraph 3(a) of Trust 1, the trustee is to distribute trust income to the Wife, or such persons as the Wife directs, in such amounts as she directs. In addition under Paragraph 10(b), Wife has the right to withdraw all or part of the assets from the trust at any time. As discussed above, in accordance with section 20.2056(b)-5(f)(8), Wife is entitled for life to all trust income, in view of her power to require that all trust assets be distributed to her. Further, the Wife's discretionary power to direct that trust income be distributed to decedent's descendants does not change this result. See Rev. Rul. 72-154, cited above. In addition, under section 20.2056(b)-5(f)(6), the requirement that the spouse be entitled for life to all of the income is satisfied if the spouse, has the right, exercisable in all events to have the corpus distributed to the spouse. Wife's power to withdraw corpus under Paragraph 10(b), satisfies this requirement. Finally, under Paragraph 10(b), Wife's power to withdraw the entire corpus at any time constitutes a power of appointment exercisable by the spouse alone, and in all events, that satisfies the requirements of section 20.2056(b)-5(g)(1).

As discussed above, Paragraph 3(b) does grant the Trustee, in the event of Wife's incapacity, discretionary authority to utilize trust income for wife's benefit or in her best interests. In addition, under Paragraph 10(b), Wife's power to revoke or amend the trust is terminated if a guardian is appointed for Wife. However, neither Paragraph 3(b) nor Paragraph 10(b) operates to terminate Wife's lifetime power to withdraw trust corpus under any circumstances. Since this power to withdraw will continue in existence even in the event of Wife's incapacity or the appointment of a guardian, the

provisions of Paragraphs 3(b) and 10(b) do not effect qualification of Trust 1 for the marital deduction under section 2056(b)(5). See Rev. Rul. 75-350, cited above; Rev. Rul. 55-518, cited above.

Accordingly, Wife is entitled for life to all of the income and possesses a general power of appointment that is exercisable by the Wife alone and in all events. The requirements of section 2056(b)(5) are satisfied with respect to Wife's interest in Trust 1. Therefore, we conclude that Wife's interest in Trust 1 qualifies for the marital deduction.

Issue 2

Under the terms of Trust 2, during Husband's life, trust income and principal is to be distributed to the Beneficiaries (Husband and Wife) or to such persons and in such amounts as Husband, or his authorized representatives, may direct. Any income that is not distributed is to be added to corpus. After Husband's death, the assets of the trust are to be held in trust for the benefit of Wife "under the provisions hereof." Accordingly, Wife's interest in Trust 2 does not constitute a qualifying income interest for life under section 2056(b)(7)(B)(ii). Under the terms of the trust, the extent to which trust income (or principal) is to be paid to Wife is within the discretion of the trustees. Thus, Wife is not entitled for life to all trust income, since the trust income may be accumulated at the discretion of the trustee.

The language of the trust is unambiguous regarding income distributions, and, accordingly, it is unnecessary to construe the instrument to determine Husband's intent. See Citation 1. Even if we considered all of the language in the trust instrument to determine the intent of Husband, there are no other provisions in the trust instrument to support a construction that Husband intended Wife to be entitled to all the income from the Trust or that Husband intended the Trust to qualify for the marital deduction under section 2056(b)(7). Therefore, we conclude that Trust 2 does not qualify for the marital deduction under section 2056(b)(7).

CAVEAT:

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