OFFICE OF
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DEPARTMENT OF THE TREASURY
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR ASSOCIATE DISTRICT COUNSEL CC:SER:GCD:BIR
ATTN:

FROM: ASSISTANT CHIEF COUNSEL (FIELD SERVICE)
CC:DOM:FS

SUBJECT: ESTATE AND GIFT TAX VALUATION AND
QTIP DEDUCTION

This Field Service Advice responds to your memorandum dated October 18, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND

Decedent
Company
Charitable Foundation
Date 1
Date 2
a%
b%
c%
d%
e%
f%
g%
h%
$x
$y

ISSUES

1. Whether decedent's transfers of stock to two inter vivos trusts and one testamentary trust should be viewed as one transaction for gift and estate tax valuation purposes.

2. Whether the QTIP trust satisfies the requirements under Internal Revenue Code § 2056(b)(7)(B)(ii).

CONCLUSIONS

1. The application of the substance over form doctrine in the present case is highly factual and depends upon whether there was substance to the transactions and whether the stock was fragmented primarily to reduce or avoid federal transfer taxes.

2. The QTIP trust appears to satisfy the requirements under section 2056(b)(7)(B)(ii).

FACTS

Decedent (hereinafter "D") was married but had no children. D held a% of the shares in Company, which comprised a majority of the outstanding shares of stock in Company. An Employee Stock Ownership Plan ("ESOP") held b% of the stock, and officers of Company held c% of the stock.

D's estate plan had three stated goals: to provide for the financial security of his wife (hereinafter "W") if she survived him; to fund Charitable Foundation; and to transfer enough of the stock that he owns in Company to the ESOP in order to ultimately give the ESOP a minimum of d% of the voting control of the Company. The will also provides that D's primary concern is to provide for W's welfare and comfort if she survives him. After W's death, D intended that the stock be transferred to the Charitable Foundation or the ESOP.

On Date 1, D executed his will, which included provisions for a testamentary trust (hereinafter "QTIP trust"). Also, on Date 1, D established two inter vivos trusts. Inter vivos trust 1 provided income to W with the remainder to the ESOP of Company. Inter vivos trust 2 provided income to W with the remainder to Charitable Foundation. D appointed W and a third party as trustees of the inter vivos trusts. The stock transferred to the inter vivos trusts was valued with a minority discount and D claimed a marital deduction under section 2523. D's estate plan fragmented his majority holding in Company resulting in each trust receiving a minority interest in Company.

D transferred c% of his Company stock to inter vivos trust 1 and e% of his stock to inter vivos trust 2. The aggregate amount of stock transferred to inter vivos trusts 1 and 2 comprised a minority interest.

On Date 2, D died. In his will, D directed that the trustees fund the QTIP trust with his residuary estate less the Company stock subject to the discount sale described below. The residue of D's estate included a minority interest in Company stock in the amount of f%. The QTIP trust provided income to W for life with remainder to Charitable Foundation. The property transferred to the QTIP trust was valued with a minority discount, and D's estate claimed a marital deduction under section 2056.

In his will, D directed that the executrix offer to sell stock to the ESOP at a discount price before the funding of the QTIP trust. Specifically, the will directed that stock with a fair market value of $x be offered to the ESOP at a g% discount. The ESOP accepted this offer and purchased stock worth $x for $y.

In his will, D also granted an option to the trustees of the ESOP to purchase enough additional shares of common voting stock at fair market value to give it control of the Company after D's death, subject to W's right not to sell during her lifetime. The will provides that as long as W is living and competent, the executrix and trustees are not under any circumstances to sell an amount of the stock which would cause the total amount of stock which W had any outright ownership or a beneficial interest under the trusts to fall below h% of the total common voting stock of the outstanding voting stock, without her written consent or direction. In addition to the initial discount offering to the ESOP, the ESOP purchased additional stock from the trust at a price that reflected a minority discount.

Upon examination of D's federal estate and gift tax returns, the Commissioner determined a higher fair market value for the Company stock for estate and gift tax purposes. Examination contends that the form of the inter vivos and testamentary transactions should not be recognized for federal tax purposes because the form does not comport with the substance of the transactions. Examination contends that when the form of the transactions are disregarded, the stock transferred by D during life and at death should be valued as one block with a control premium.

Examination determined that the testamentary trust does not constitute qualified terminable interest property because (1) the Company stock was sold to the ESOP at a price that does not reflect a control premium; and (2) the will provided for a discount sale to the ESOP.

LAW AND ANALYSIS

Issue 1

Examination contends that the form of the inter vivos and testamentary transactions should not be recognized for federal tax purposes because the form does not comport with the substance of the transactions. When the form of the transactions are disregarded, Examination contends that the value of the stock transferred by D during life and at death should reflect a control premium.

It is a well established legal principle that the form of a transaction will be recognized for federal tax purposes only if it comports with the substance of the transaction. See Knetsch v. United States, 364 U.S. 361 (1960); Gregory v. Helvering, 293 U.S. 465 (1935). In appropriate situations, the courts have demonstrated a willingness to disregard transfers undertaken to avoid or reduce transfer taxes. Compare Estate of Murphy, T.C. Memo. 1990-472 (court applied substance over form doctrine and disregarded multiple transfers where the sole purpose of the transfers was to fragment a controlling interest in a corporation) with Estate of Frank v. Commissioner, T.C. Memo 1995-132 (court declined to apply substance over form doctrine to disregard the form of transfers). Courts have also rejected attempts to avoid taxation of the control value of stock holdings through fragmentation of a controlling interest. See Estate of Cidulka v. Commissioner, T.C. Memo 1996-149 (donor's gifts of minority stock interests to shareholders followed by a redemption of donor's interest in the corporation treated as a single transfer of a controlling interest); Estate of Griffin v. United States, 42 F. Supp. 2d 700 (W.D. Tex. 1998) (transfer of one-half of donor's stock to donor's spouse followed by a transfer of stock by spouse and donor to children treated as one gift by donor of the entire block).

The application of the substance over form doctrine in the present case is highly factual and depends upon whether there was substance to the transactions and whether the stock was fragmented primarily to reduce or avoid federal transfer taxes. If the facts as developed do not support the application of the substance over form doctrine, the stock that was transferred to the inter vivos trusts should be valued pursuant to section 2512, and the stock that was bequeathed should be valued pursuant to section 2031.

Issue 2

Section 2056(a) of the Code provides that for purposes of the tax imposed by section 2001, the value of the taxable estate shall, except as limited by section 2056(b), be determined by deducting from the value of the gross estate an amount equal to the value of any interest in property which passes or has passed from the decedent to his surviving spouse, but only to the extent that such interest is included in determining the value of the gross estate.

Under section 2056(b)(1), a marital deduction is not allowed for certain terminable interests in property. Section 2056(b)(1) provides, in part, that where, on the lapse of time, on the occurrence of an event or contingency, or on the failure of an event or contingency to occur, an interest passing to the surviving spouse will terminate or fail, no deduction shall be allowed under this section with respect to such interest– (A) if an interest in such property passes or has passed (for less than an adequate and full consideration in money or money's worth) from the decedent to any person other than such surviving spouse (or the estate of such spouse); and (B) if by reason of such passing such person (or his heirs or assigns) may possess or enjoy any part of such property after such termination or failure of the interest so passing to the surviving spouse.

Under certain circumstances, a marital deduction may nevertheless be allowable with respect to a terminable interest passing to a surviving spouse. See sections 2056(b)(7) and 2056(b)(5). Section 2056(b)(7) provides that, in the case of qualified terminable interest property, such property shall be treated as passing to the surviving spouse for purposes of 2056(a) and for purposes of section 2056(b)(1)(A), no part of the property shall be treated as passing to any person other than the surviving spouse.

Section 2056(b)(7)(B)(i) defines "qualified terminable interest property" as 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, in part, that a 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, or has a usufruct interest for life in the property, and (II) no person has a power to appoint any part of the property to any person other than the surviving spouse.

The QTIP marital deduction provisions are intended to provide a special tax benefit that permits property to pass to the surviving spouse without the decedent's estate paying tax on its value. Tax is deferred on the transfer until the surviving spouse either dies or makes a lifetime disposition of the property. Sections 2044 and 2519. Under either circumstance, a transfer (estate or gift) tax is paid. See United States v. Stapf, 375 U.S. 118 (1963); Estate of Clayton v. Commissioner, 976 F.2d 1486 (5th Cir. 1992); and Estate of Letts v. Commissioner, 109 T.C. 290 (1997).

The determination of whether an interest is terminable is made as of the decedent's death. Jackson v. United States, 376 U.S. 503 (1964). See also, Murray v. United States, 687 F.2d 386 (Ct. Cl. 1982); Estate of Wycoff v. Commissioner, 506 F.2d 1144 (10th Cir. 1974);and Estate of Weisberger v.Commissioner, 29 T.C. 217 (1957). Whether or not an interest is a terminable interest is to be determined by reference to the property interest which actually passed from the decedent. Treas. Reg. § 20.2056(b)-1(e)(3).

In his will, D directed that the executrix offer to sell stock to the ESOP at a discount price before funding the QTIP trust. Specifically, the will directed that stock with a fair market value of $x be offered to the ESOP at a g% discount. The ESOP accepted this offer and purchased stock worth $x for $y.

In his will, D also granted an option to the trustees of the ESOP to purchase enough additional shares of common voting stock at fair market value to give it control of the Company after D's death, subject to W's right not to sell during her lifetime. The will provides that as long as W is living and competent, the executrix and trustees are not under any circumstances to sell an amount of the stock which would cause the total amount of stock which W had any outright ownership or a beneficial interest under the trusts to fall below h% of the total common voting stock of the outstanding voting stock, without her written consent or direction. In addition to the initial discount offering to the ESOP, the ESOP purchased additional stock from the trust at a price that reflected a minority discount.

Examination determined that the testamentary trust does not consititute qualified terminable interest property because (1) the Company stock was sold to the ESOP at a price that does not reflect a control premium; and (2) the will provided for a discount sale to the ESOP.

The property in the QTIP trust transferred to W is a terminable interest because W's interest terminates on her death, at which time the trust corpus passes to other beneficiaries. Treas. Reg. § 20.2056(b)-1(b). In order for this interest to qualify for the marital deduction, the property must pass from the decedent, the surviving spouse must be entitled to all the income from the property, payable annually or at more frequent intervals, no person may have a power to appoint any part of the property to any person other than the surviving spouse and an election must be made with respect to the property on the federal estate tax return. Section 2056(b)(7)(B).

Upon review of the will and trust, it appears that the property that passed to W satisfies the requirements of section 2056(b)(7)(B)(ii). The first requirement is satisfied because under D's will, W is entitled to all of the income from the QTIP trust payable in as frequent installments as may be practicable and in any event once every three months. The second requirement is also satisfied because the terms of the will and trust documents do not provide any person with a power to appoint any part of the property to any person other than the surviving spouse.

The discount sale to the ESOP does not disqualify the trust property for the marital deduction because the will directs that some of the stock be offered to the ESOP at a discount at the time of D's death, and the QTIP trust is funded after and subject to the discount sale. See Estate of Rinaldi v. United States, 38 Fed. Cl. 341 (1997). You have informed us that D's estate claimed a marital deduction for $y but the executor included $x in D's gross estate. The fact that stock worth $x was sold for $y to the ESOP affects the amount of the marital deduction and not the eligibility of the QTIP trust for the deduction.

D's will also provides an option to the trustees of the ESOP to purchase, at fair market value, additional shares of stock after D's death, subject to W's right not to sell during her lifetime. The fact that D directed in his will that the stock be sold at fair market value does not constitute a power to appoint any part of the property to a third party. Provided the sale proceeds are reinvested in the QTIP trust by the trustees, the transfer tax will be deferred until the surviving spouse either dies or makes a lifetime disposition of the property. Sections 2044 and 2519.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[redacted]

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Please call if you have any further questions.

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