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INTERNAL REVENUE SERVICE
TECHNICAL ADVICE MEMORANDUM

Taxpayer's Name:
Taxpayer's ID Number:
Taxpayer's Address:

Date of Death:
Area:
Conference held:

LEGEND:

Decedent =
Spouse =
C =
D =
Trust =
$s =
$t =
Date 1 =
Date 2 =
Date 3 =
Date 4 =
Date 5 =
Date 6 =

Issue: To what extent does the residuary marital bequest under Article IV of Decedent's will qualify for the estate tax marital deduction under § 2056(a) of the Internal Revenue Code?

Conclusion: In determining the amount deductible under § 2056(a) with respect to the residuary marital bequest under Article IV of Decedent's will, the value of the residuary bequest claimed as a deduction by the Decedent's estate must be reduced by $375,000 to reflect the amount paid by Spouse to Trust.

FACTS:

On Date 1, Decedent executed Trust naming Spouse as trustee. At that time, Trust was funded with one dollar in cash. Article II(A) of Trust provides that the trustee

is to divide the Trust property into two separate trusts, equal in value. One of the trusts is to be held for the primary benefit of Decedent's and Spouse's daughter, C, and the other trust is to be held for the primary benefit of Decedent's and Spouse's son, D.

Under Article II(C) the trustee is to distribute to the beneficiary of each trust, and to such beneficiary's descendants, such amounts of income and principal as are necessary, when added to the funds reasonably available to such beneficiary from other sources to provide for such beneficiary's health, support, maintenance and education.

Article II(F) provides that each trust created under Article II for a beneficiary who is one of Decedent's children shall last for such beneficiary's lifetime and shall terminate upon such beneficiary's death. When such beneficiary attains age 32 and one-half, $100,000 is to be distributed to a separate trust for the sole benefit of that child. The child shall be the sole trustee of the separate trust and it shall be maintained, operated and distributed by the child as trustee as under the same terms and conditions as set forth in the trust originally established for the child. When a child attains age 35, then an additional $100,000 of trust property from the trust originally established for the child is to be transferred to the separate trust to be held under the same terms. Upon the child attaining age 40, the balance of the trust originally established for the child is to be added to the separate trust. Upon the termination of a trust created under Article II, all of the remaining unappointed property of such trust is to be distributed to such beneficiary's separate trust or, if the beneficiary's death is the event that terminates the trust, such property shall be distributed to such beneficiary's then living descendants per stirpes.

Article VII(B) of Trust provides that the Grantor or any other person may at any time grant, transfer or convey, either by inter vivos transfer or by will, to the Trustee such additional property as he or she desires to become part of the trusts created under this Trust Agreement.

Also on Date 1, Decedent executed her Last Will and Testament, naming Spouse as executor. Article IV of Decedent's will provides as follows:

> I give all of the residue of my estate to my husband if he survives me; provided, however, if the [Trust] dated __day of _____, 1997 [sic] is not funded with property having a fair market value, as of the date of funding, of One Million and no/100 Dollars ($1,000,000), then property from my estate shall be added to that trust to bring the fair market value of the funded amount to One Million and no/100 Dollars ($1,000,000). This supplemental funding, if any, shall occur not less than one hundred twenty (120) days after the date of my death, and the judgment as to whether or not additional funds are required shall be made by my Executor on the ninetieth (90th) day following the date of my death.

Decedent died on Date 2. As of Date 2, no additions had been made to Trust. Thus, the Trust corpus was still $1.00 as of Date 2. On Date 3, the Decedent's federal estate tax return (Form 706) was filed. The estate tax return reported that pursuant to Article IV, $625,000 from Decedent's estate was to be distributed to Trust. The estate claimed an estate tax marital deduction for the value of the residuary estate passing to Spouse under Article IV that reflected a reduction for the $625,000 to be distributed to Trust. On Date 4, over one and one-half years after Decedent's death, Spouse transferred $375,000 to Trust. Between Date 5 and Date 6, Spouse, as Decedent's executor, distributed $625,000 in estate assets to Trust.

LAW AND ANALYSIS:

Section 2001 imposes a tax on the taxable estate of every decedent who is a citizen or resident of the United States.

Section 2056(a) provides that, for purposes of the tax imposed by § 2001, the value of the taxable estate is to be determined by deducting from the value of the gross estate an amount equal to the value of any interest in property that passes or has passed from the decedent to the surviving spouse.

Section 2056(b)(1) provides an exception to the general rule of § 2056(a) in the case of "terminable interests" passing to the spouse. Under § 2056(b)(1), if 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 is allowed under § 2056 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.

Section 2056(b)(4) provides that for purposes of determining the value of any interest in property passing to the surviving spouse for which a deduction is allowed–

> (A) there shall be taken into account the effect which the tax imposed by § 2001, or any estate, succession, legacy, or inheritance tax, has on the net value to the surviving spouse of such interest; and
>
> (B) where such interest or property is encumbered in any manner, or where the surviving spouse incurs any obligation imposed by the decedent with respect to such interest, such encumbrance or obligation shall be taken into account in the same manner as if the amount of a gift to such spouse of such interest were being determined.

Example 1, under § 20.2056(b)-4(b), illustrates the application of § 2056(b)(4). In the example, a decedent devised a residence valued at $25,000 to his wife, with a direction that she pay $5,000 to his sister. The example concludes that for purposes of the marital deduction, the value of the property interest passing to the wife is only $20,000.

The legislative history underlying the enactment of the predecessor to § 2056 provides this discussion regarding the amount deductible for marital deduction purposes.

> The interest passing to the surviving spouse from the decedent is only such interest as the decedent can give. If the decedent by his will leaves the residue of his estate to the surviving spouse and she pays, or if the estate income is used to pay, claims against the estate so as to increase the residue, such increase in the residue is acquired by purchase and not by bequest. Accordingly, the value of any such additional part of the residue passing to the surviving spouse can not be included in the amount of the marital deduction.

S. Rep. No. 1013, 80th Cong., 2d Sess. Part 2, 6 (1948), 1948-1 C.B. 285, 335.

Under § 2056(b)(4), the marital deduction is limited to the net value of the interest passing to the surviving spouse. Thus, the value of any interest passing to the surviving spouse must be reduced by any encumbrances upon the interest or any obligation imposed by the decedent with respect to the passing of the interest to the surviving spouse. Similarly, in a case where obligations which are payable out of the interest passing to a surviving spouse are discharged by the surviving spouse voluntarily from his or her own funds, the marital deduction is limited to the net amount received from the decedent, i.e., the value of the property devised to the surviving spouse in excess of the spouse's voluntary contributions.

This latter point was illustrated in Estate of Denman v. Commissioner, 33 T.C. 361 (1959), aff'd, 287 F. 2d 725 (6th Cir. 1961). In Estate of Denman, under state law,

the decedent's surviving spouse was entitled to a set-off and support allowance totaling $5,500. However, the probate estate did not contain sufficient liquid assets to pay these items. Accordingly, the surviving spouse contributed funds to the estate and these funds were used to pay the set-off and allowance. The estate then claimed a marital deduction for the allowance paid to the spouse. The court concluded that a marital deduction was not allowable with respect to the payment, as follows:

> [S]he advanced moneys from her own funds to the estate and, for reasons undisclosed by the record, she, as executrix satisfied her claims the same day by paying herself the statutory allowances with checks drawn on the estate. Thus, as we see it, the claims were not paid from assets of the estate and we do not see how it can be said that they

> passed "from the decedent to his surviving spouse" within the meaning of the language of the statute providing for the marital deduction.

Estate of Denman v. Commissioner , 33 T.C. at 364.

Similarly, the application of the predecessor to § 2056(b)(4) was at issue in United States v. Stapf, 375 U.S. 118 (1963). In Stapf, the Decedent's will put his surviving spouse to an election to either retain her one-half interest in the couple's community property or take the benefits under the will and allow her community property to be disposed of under the terms of the will. The spouse elected to take under the terms of the will. Consequently, she received one-third of the combined community property and one-third of the decedent's separate property. Her one-half interest in the community property passed under the terms of the will, to a trust for the benefit of the couple's children. The government argued that in determining the amount of the marital deduction, the value of the property passing to the spouse had to be reduced by the value of the property she was required to transfer to another as a condition for receiving the property. The Court agreed, stating:

> In the present case, the effect of the devise was not to distribute wealth to the surviving spouse, but instead to transmit through the widow, a gift to the couple's children. . . .What the statute provides is a "marital deduction" - a deduction for gifts *to the surviving spouse* - not a deduction for gifts to the children . . . . The appropriate reference, therefore, is not to the value of the gift moving from the deceased spouse but the net value of the gift received by the surviving spouse.

United States v. Stapf, 375 U.S. at 125. The Court further concluded that the allowable deduction is limited to "the net economic interest received by the surviving spouse," and that this rule applies regardless of whether the surviving spouse is required to make a payment out of the property received, or is required to make a payment from the surviving spouse's own funds, in order to receive the bequest. United States v. Stapf, 375 U.S. at 126.

In the present case, Decedent's will provided that to the extent Trust was not funded with property having a fair market value, as of the date of funding, of $1,000,000, then property from Decedent's estate was to be added to Trust to bring the value of Trust to $1,000,000. The residue of the estate remaining after funding Trust passed to Spouse. Thus, the interest in the residue that passed to Spouse was subject to the obligation, imposed by Decedent's will, to fund Trust with up to $1,000,000. It appears that by the time the Decedent's estate tax return was filed, it had been determined that only $625,000 of estate funds were required to fund Trust, because the remaining $375,000 was to be paid by Spouse. As in Denman, supra, Spouse, in effect, partially discharged the $1,000,000 pre-residuary obligation under Article IV of the will by voluntarily transferring $375,000 of his own funds to Trust, thereby increasing the amount of the residuary passing to him by $375,000. As was the result in Estate of Denman , the only property that is considered to have passed from Decedent to Spouse

is the value of the residue in excess of the spouse's voluntary contribution of $375,000. As discussed in the legislative history discussed above, Spouse purchased the $375,000 increase in the residue by transferring the identical amount to Trust. The $375,000 increase in the residue did not pass to Spouse by devise. See also, Estate of Wycoff v. Commissioner, 506 F. 2d 1144 (10th Cir. 1974) and Rev. Rul. 79-14, 1979-1 C.B. 310 (marital deduction for spousal bequest must be reduced under § 2056(b)(4) to the extent the fiduciary has the discretion to pay estate taxes from the bequest, even if the taxes are paid from other sources).

Similarly, we believe the Court's decision in United States v. Stapf also supports this result. That is, in the instant case, the amount of the residuary bequest passing to Spouse was dependent on the amount of estate assets required to fully fund the $1,000,000 bequest to Trust. To the extent additions were made to Trust after the date of death, the portion of the $1,000,000 not required to fund Trust would pass to the Spouse. Spouse, after the date of decedent's death contributed $375,000 to Trust. As a result, an additional $375,000 passed through the residuary estate to Spouse. However, as was the case in Staph, the additional $375,000 distributed to Spouse as part of the residuary bequest, for which a marital deduction was claimed, passed to Spouse only because Spouse contributed the same amount to Trust. The effect of the residuary bequest, to the extent of $375,000, was not to distribute wealth to Spouse, but rather to transmit a gift to Trust through Spouse. Thus, under § 2056(b)(4)(B), in determining the allowable marital deduction with respect to the residuary bequest, the residuary bequest must be reduced by the $375,000 that Spouse transferred to Trust. Under Staph, the residue as reduced by $375,000 represents "the net value of the gift received by the surviving spouse."

In the alternative, we believe the residuary bequest received by Spouse, to the extent of $375,000, would constitute a nondeductible terminable interest under §2056(b)(1). In Estate of Ray v. Commissioner, 54 T.C. 1170 (1970), the decedent bequeathed her residuary estate to her spouse on condition that the spouse agree in writing, within 4 months of the decedent's death, to bequeath, on his death, an amount equal to the value of the residuary estate to their daughter. The court found that the residuary spousal bequest was conditioned on the spouse's agreement to make a testamentary transfer to his daughter. If the spouse failed to agree to the transfer, the spousal bequest would terminate and the residue would pass for the benefit of the decedent's daughter. Accordingly, the conditional bequest constituted a nondeductible terminable interest under §2056(b)(1). See also, Allen v. United States, 359 F. 2d 151(2d Cir. 1966); Estate of Edmonds v. Commissioner, 72 T.C. 970 (1979) ($100,000 bequest to spouse conditioned on spouse's relinquishment of a life estate in the decedent's house and purchase of a different residence held to be a nondeductible terminable interest); Rev. Rul. 82-184, 1982-2 C.B. 215.

In the instant case, as was the case in Estate of Ray and Estate of Edmonds, there was a significant condition precedent to the Spouse's acquisition of the entire enhanced residue (i.e., the residue including up to $1,000,000). That is, in order to acquire the enhanced residue, either the Spouse, or another person, was required to

contribute funds to Trust of up to $1,000,000. In the absence of the contribution, the residuary bequest to Spouse, up to $1,000,000, would terminate or fail, and the property would pass to Trust. As was the case in Estate of Ray, the requirement that Spouse contribute funds to Trust in order to receive the identical increase in the residuary bequest, or that a third party contribute funds to Trust for no consideration, constitutes a significant condition precedent to Spouse's acquisition of that portion of the residuary bequest. Accordingly, in this case, since $625,000 of estate assets were used to fund Trust (and a marital deduction was not claimed for these assets), the marital deduction claimed by the estate for the residuary bequest passing to Spouse should be disallowed to the extent of $375,000, as constituting a nondeductible terminable interest under § 2056(b)(1).

The estate argues that § 2056(b)(4)(B) and the regulations thereunder are not applicable in this situation. In this case, Spouse was under no obligation to transfer any property to Trust as a condition to receiving the residuary bequest. Rather, whether or not Spouse (or any other person) transferred funds to Trust, Spouse would receive the residuary bequest, in all events, subject only to fluctuations in value depending on whether a contribution was made to Trust.

The estate also argues that no part of the residuary bequest is a nondeductible terminable interest. The estate cites Rev. Rul 90-3, 1990-1 C.B. 174, in which the date of death value of the D's gross estate was $900,000. D's will provided for a $600,000 pre-residuary pecuniary bequest of to D's child with the residue passing to D's spouse. The executor could satisfy the pecuniary bequest in cash, or in kind at the fair market value of the applicable assets at the date of distribution. At the time of distribution, the value of the gross estate had declined to $700,000. After distributing the $600,000 pecuniary bequest, and the payment of expenses of $50,000, the value of the residue that passed to the spouse was $55,000, instead of the $250,000 value of the residue at the time of D's death. The ruling holds that the possibility that post death fluctuations in the value of estate assets may significantly diminish the residuary bequest to the spouse does not cause the residuary bequest to be a nondeductible terminable interest. The estate also relies on Estate of Smith v. Commissioner, 565 F.2d 455 (7th Cir. 1977), acq. 1982-1 C.B.1, where the court held that property passing to spouse under a marital deduction "equalization clause" pursuant to which the amount passing to the spouse was dependent on the value of the assets owned by the spouse, determined as of the alternate valuation date, was fully deductible and not a terminable interest. In Rev. Rul. 82-23, 1982-1 C. B. 139, the Service announced that it would follow Estate of Smith and other equalization cases.

The estate argues that the residuary bequest in the instant case is similar to a formula bequest. Pursuant to the formula, although the bequest will increase in amount if Spouse or a third party funds Trust, or will decrease if nothing is contributed to Trust, Spouse's interest in the bequest will not terminate. Rather, based on Estate of Smith, and Rev. Rul. 90-3, the fact that the value of the residue bequest may fluctuate depending on whether any person makes a post-death contribution to Trust does not effect the qualification of the residuary bequest for the marital deduction, or the amount

allowable as a deduction. Rather, the Spouse's vested right to the entire residuary marital bequest was fixed on Decedent's death.

We disagree with the estate's arguments. First, there is no indication that the analysis in Staph, Denman, or § 20.2056(b)-4(b), Example 1, would be any different if the bequests involved in those cases were residuary bequests. Indeed it would seem that regardless of whether the spousal bequest takes the form of a pecuniary bequest of a specific sum of money, a specific bequest of tangible or real property, or a residuary bequest of whatever is left over after payment of certain items, if the spouse is required to transfer property to another in order to acquire the bequest, or voluntarily pays a claim that has the effect of enhancing the bequest, the marital deduction must be reduced to reflect "the net value of the gift received by the surviving spouse." United States v. Stapf, 375 U.S. at 125. Indeed, the paragraph quoted above from the legislative history underlying the marital deduction provisions, references a spousal residuary bequest that is increased as a result of the spouse's voluntary payment of estate claims. The example concludes that the marital deduction allowable for the residuary bequest must be reduced to reflect the spouse's payment. S. Rep. No. 1013, 80th Cong., 2d Sess. Part 2, 6 (1948), 1948-1 C.B. 285, 335.

Further, we believe the situation presented here is distinguishable from the situations presented in Estate of Smith, Rev. Rul. 82-23 and Rev. Rul. 90-3. In Estate of Smith and the revenue rulings, the date of death value of the spousal bequest could fluctuate, but only due to market conditions. There was no possibility that any portion of the spousal bequest would be diverted to other beneficiaries dependent on the failure of an event to occur such as a volitional transfer by a party. For example, in the fact situation presented in Rev. Rul. 82-23, in determining the amount necessary to equalize the estates, the value of the surviving spouse's assets was to be determined as of the date of death, and any post-death dispositions by the surviving spouse of her assets was to be ignored. This is significantly different from the instant case where up to $1,000,000 of the residuary marital bequest was subject to being diverted to Trust if Spouse, or another party, did not act post-death to fund Trust. Under the circumstances presented, we believe the action required to be taken in this case (either by the Spouse or a third party) in order that Spouse receive the $1,000,000 portion of the residue was a significant condition precedent for purposes of the terminable interest rule under §2056(b)(1). See, Estate of Ray, supra (involving a spousal residuary bequest); Estate of Edmonds, supra.

Accordingly, in determining the amount deductible under § 2056(a) with respect to the residuary marital bequest under Article IV of Decedent's will, the value of the residuary bequest claimed as a deduction by the estate must be reduced by $375,000 to reflect the amount paid by Spouse to Trust.

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

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