Office of Chief Counsel
Internal Revenue Service
Memorandum

Number: **202118008**
Release Date: 5/7/2021

CC:PSI:B04:JRKim/SEWolf
POSTS-111954-20
POSTS-111955-20
POSTS-111956-20

Third Party Communication: None
Date of Communication: Not Applicable

UILC: 2511.00-00, 2519.00-00

date: February 01, 2021

to: Michael Skeen
Associate Area Counsel
(San Francisco, Group 3)
(Small Business/Self-Employed)

Attn: Daniel J. Bryant

from: Karlene M. Lesho
Senior Technician Reviewer, Branch 4
Associate Chief Counsel
(Passthroughs & Special Industries)

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subject: Gift Tax Examination

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Spouse	=
Decedent	=
Child 1	=
Child 2	=
Trust 1	=
Trust 2	=
Trust 3	=
Year	=
Date 1	=
Date 2	=
Date 3	=

Agreement =
Date 4 =
State Statute =
Corporation =
LLC 1 =
LLC 2 =
LLC 3 =
LLC 4 =
Savings Account =
Brokerage Account =
Children's Trusts =

a =
b =
c =
d =
e =
f =
g =
r =
s =
t =
u =
v =
w =
x =
y =
z =

ISSUES

1. Whether the commutation of a trust for which an election under § 2056(b)(7) is effective is a disposition of the surviving spouse's qualifying income interest that is subject to § 2519 of the Internal Revenue Code (Code).
2. Whether the distribution of all of the trust property to the surviving spouse pursuant to an agreement results in a gift of the remainder interest by the remainder beneficiaries under § 2511.
3. Whether the commutation of the trust and the distribution of all of the trust property to the surviving spouse result in offsetting reciprocal gifts between the surviving spouse and the remainder beneficiaries.
4. How is the value of the gift from the surviving spouse to the remainder beneficiaries under § 2519 determined?
5. How is the value of the gift from the remainder beneficiaries to the surviving spouse determined?

CONCLUSIONS

1. The commutation of the trust is a disposition of the surviving spouse's qualifying income interest within the meaning of § 2519(a), and thus, the surviving spouse is treated as making a gift of all of the interests in the trust other than the qualifying income interest.
2. The distribution of all of the trust property to the surviving spouse constitutes a transfer of the remainder interest and a gift by the remainder beneficiaries under § 2511.
3. The commutation and the distribution of all of the trust property to the surviving spouse are separate gift transfers by separate donors, the surviving spouse and the remainder beneficiaries, that do not offset each other.
4. The value of the surviving spouse's § 2519 gift to the remainder beneficiaries is the fair market value of all of the interests in the trust less the present value of the qualifying income interest on the date of disposition (as determined under § 7520).
5. The value of the remainder beneficiaries' gifts under § 2511 to the surviving spouse is the value of their remainder interest in the trust. In the absence of the trustee's computation of this amount, the Service will make its own determination pursuant to the valuation rules set forth in § 7520.

FACTS

This is a request for assistance from SB/SE Examination with regard to the examination of Year Forms 709 (United States Gift (and Generation-Skipping Transfer) Tax Return) of Spouse, Child 1, and Child 2.

On Date 1, Decedent died testate, survived by Spouse and adult children, Child 1 and Child 2 (collectively, Children). Pursuant to Decedent's will, three trusts were created: Trust 1, Trust 2, and Trust 3. The assistance requested pertains to Trust 1 only.

Trust 1 was funded with the residue of Decedent's estate. Trust 1 directs all income to be distributed to Spouse at least annually and authorizes principal distributions for Spouse's health, maintenance, and support in Spouse's accustomed manner of living if the income is insufficient for such purposes. Trust 1 grants Spouse a testamentary limited power of appointment in favor of Decedent's descendants. In the absence of Spouse's exercise of Spouse's testamentary limited power of appointment, Trust 1 directs the remainder to be distributed outright to Children, by right of representation.

Decedent's estate timely filed a Form 706 (United States Estate (and Generation-Skipping Transfer) Tax Return). On Schedule M of Form 706, Spouse, as personal representative, elected to treat the property of Trust 1 as qualified terminable interest property (QTIP) under § 2056(b)(7). As reported on the Form 706, Trust 1 was funded with $a of property.

On Date 3, Spouse, as the current beneficiary and as the trustee of Trust 1, and Child 1 and Child 2, as remainder beneficiaries and virtual representatives of the contingent and

unborn beneficiaries of Trust 1, entered into Agreement. Under the terms of Agreement, Trust 1 was commuted[1] and all of its property was distributed to Spouse. Recital H of Agreement provides that Spouse and Children agree that "Trust assets could be more effectively utilized if [Spouse] held such assets outright and free of trust." In Recital F of Agreement, the parties acknowledge that Spouse's testamentary limited power of appointment is "not operative." Paragraph 3 of Agreement provides:

> By signing this Agreement and by virtue of the QTIP election for the Trust, the commutation of the Trust results in a deemed gift, for federal gift tax purposes, of the remainder interest in the Trust assets from [Spouse] to [Children] under Section 2519 of the Code. By virtue of the distribution of all of the Trust assets to [Spouse], the commutation of the Trust does not result in a deemed gift of [Spouse's] income interest in the Trust under Section 2511 of the Code. Additionally, by signing this Agreement and by virtue of the distribution of all of the Trust asset [sic] to [Spouse], the commutation of the Trust results in a gift, for federal gift tax purposes, of the remainder interest in the Trust from [Children] to [Spouse]. The deemed gift of the remainder interest from [Spouse] to [Children] and the gift from [Children] to [Spouse] results in a reciprocal gift transfer.

Paragraph 5 of Agreement provides that (i) Agreement will have the same effect as a court decree, as described in State Statute, (ii) Agreement will become legal and effective upon the date of the last signature of the parties (Date 3), (iii) the terms of Agreement are enforceable as a nonjudicial agreement and as a contract, and (iv) Agreement "contains the entire agreement and understanding among the parties hereto with respect to the subject matter hereof."

At the time of the commutation, the combined value of the property held by Trust 1 was $b, consisting of r Class A shares of Corporation, s Class B shares of Corporation, t% interest in LLC 1, u% interest in LLC 2, v% interest in LLC 3, v% interest in LLC 4, Savings Account, and Brokerage Account. After the commutation and Children's gifts of their remainder interests to Spouse, Spouse owned all of trust property outright.

Also on Date 3, and with the property Spouse owned outright pursuant to Agreement, Spouse entered into a series of transactions. Spouse transferred by gift w Class B shares of Corporation (valued at $c) to irrevocable dynasty trusts that Spouse had established on Date 2 for the collective benefit of Children and their descendants (Children's Trusts). In addition, in exchange for promissory notes with an aggregate face amount of $d, Spouse transferred to Children's Trusts (i) the entire interest in

[1] A commutation terminates a trust by distributing trust property to trust beneficiaries based on the respective values of their beneficial interests.

LLC 1, (ii) all of the Class A shares of Corporation, and (iii) x Class B shares of Corporation.[2]

On Date 4, Spouse, Child 1, and Child 2, each filed a Form 709 for Year. Each Form 709 reported the commutation and distribution of the trust property from Spouse to Child 1 and Child 2 to be "deemed to be the same value as the property transferred from [Child 1 and Child 2] to [Spouse]" and asserted that the amounts of the gifts are zero.

LAW AND ANALYSIS

ISSUE 1: Application of § 2519 to Spouse

Section 2519(a) provides that for purposes of chapter 11 and 12 of the Code (relating to estate and gift taxes), any disposition of all or part of a qualifying income interest for life in any property to which § 2519 applies shall be treated as a transfer of all interests in such property other than the qualifying income interest. Section 2519(b) provides that § 2519(a) applies to any property if a deduction was allowed with respect to the transfer of such property to the donor under § 2056(b)(7).

Section 25.2519-1(a) of the Gift Tax Regulations provides in relevant part, that if a donee spouse makes a disposition of all or part of a qualifying income interest for life in any property for which a deduction was allowed under § 2056(b)(7) for the transfer creating the qualifying income interest, the donee spouse is treated for purposes of chapters 11 and 12 as transferring all interests in property other than the qualifying income interest. A transfer of the income interest of the spouse is a transfer by the spouse under § 2511.

Section 25.2519-1(c)(1) provides that the amount treated as a transfer under § 2519 upon a disposition of all or part of a qualifying income interest for life in QTIP is equal to the fair market value of the entire property subject to the qualifying income interest, determined on the date of the disposition, less the value of the qualifying income interest in the property on the date of the disposition. The gift tax consequences of the disposition of the qualifying income interest are determined separately under § 25.2511–2.

Section 25.2519-1(f) provides in relevant part, that the sale of QTIP, followed by the payment to the donee spouse of a portion of the proceeds equal to the value of the donee spouse's income interest, is considered a disposition of the qualifying income interest.

In *Estate of Novotny v. Commissioner*, 93 T.C. 12 (1989), the surviving spouse and

[2] We do not address the gift and estate tax consequences of the transfers in exchange for the promissory notes.

remainderman divided the sale proceeds of QTIP proportionately on the basis of the respective values of their interests; the court indicated that the commutation constituted a disposition by the spouse of the income interest for purposes of § 2519 and was thus subject to gift tax.

In this case, Spouse, as personal representative of Decedent's estate, made an election under § 2056(b)(7) to treat Trust 1 as QTIP and claimed a marital deduction on Decedent's Form 706 for the value of Trust 1. Years later, on Date 3, Spouse and Children entered into Agreement. By its terms, Agreement effected the commutation of Trust 1.

In a commutation, the trustee makes terminating distributions to the holders of the beneficial interests in the trust equal to the actuarial value of the interests. Each beneficiary gives up his or her respective beneficial interest in exchange for a lumpsum payment, in what is essentially a sale transaction. The commutation terminates any relationship between the beneficiary and the trust, and if all interests are commuted, the trust terminates.

Based on the above, the commutation of Trust 1 effected by Agreement constitutes a disposition by Spouse of Spouse's qualifying income interest within the meaning of § 2519(a). Section 25.2519-1(a) and (f); *Estate of Novotny*. Accordingly, for gift tax purposes, Spouse is treated as transferring by gift all interests in Trust 1 other than the qualifying income interest.[3]

ISSUE 2: Gift by Children under § 2511

Section 2501(a)(1) imposes a tax for each calendar year on the transfer of property by gift during the calendar year by an individual.

Section 2511(a) provides in part that the tax imposed by § 2501 shall apply whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal and tangible or intangible.

Section 25.2511-2(a) provides that the gift tax is not imposed upon the receipt of the property by the donee, nor is it necessarily determined by the measure of enrichment resulting to the donee from the transfer, nor is it conditioned upon ability to identify the donee at the time of the transfer. On the contrary, the tax is a primary and personal liability of the donor, is an excise upon donor's act of making the transfer, is measured by the value of the property passing from the donor, and attaches regardless of the fact that the identity of the donee may not then be known or ascertainable.

[3] Note that the commutation does not constitute a gift of Spouse's qualifying income interest under § 2511 because Spouse received adequate and full consideration for Spouse's qualifying income interest based on the distribution of all trust property to Spouse. *See* § 25.2519-1(g), *Example 2*.

Section 25.2511-2(b) provides that as to any property, or part thereof or interest therein, of which the donor has so parted with dominion and control as to leave in him no power to change its disposition, whether for donor's own benefit or the benefit of another, the gift is complete.

Section 2512(b) provides that where property is transferred for less than an adequate and full consideration in money or money's worth, the amount by which the value of the property exceeds the value of the consideration is deemed a gift.

In this case, Child 1, Child 2, and Spouse entered into Agreement, which legally bound all persons interested in Trust 1. The effect of Agreement was to extinguish Spouse's testamentary limited power of appointment, commute Trust 1, and terminate Trust 1. As a result, Agreement vested a valuable property interest (the value of the remainder) in Children, the then remaindermen. Rather than accept a terminating distribution of the value of their beneficial interest, Child 1 and Child 2 agreed that the trust property "could be more effectively utilized" by Spouse holding the property outright. The outright distribution of all trust property to Spouse pursuant to the terms of Agreement constitutes a transfer of the value of Children's remainder interests without receipt of adequate and full consideration.[4] Accordingly, Child 1 and Child 2 each made a gift under § 2511 of the value of their respective remainder interest in Trust 1 to Spouse. Section 2512(b).

ISSUE 3: Reciprocal Exchange for Consideration in Commutation of QTIP Trust

Adequate and Full Consideration for Purposes of § 2512(b) and Reciprocal Transfers

In *Commissioner v. Wemyss*, 324 U.S. 303 (1945) and its companion case *Merrill v. Fahs*, 324 U.S. 308 (1945), the Supreme Court considered the gift tax meaning of the term "adequate and full consideration in money or money's worth" in the context of antenuptial contracts.

In *Wemyss*, the donor transferred assets to his fiancé to compensate her for the loss of an income interest that would terminate upon her marriage to him. There was no dispute that both a promise of marriage and detriment to a contracting party constituted valuable consideration for purposes of the law of contracts. The Tax Court had held that if the promise of marriage was the consideration, it was not one reducible to a money value and, if the fiancé's loss of the income interest was the consideration, it did not constitute consideration in the hands of the donor. The Supreme Court stated:

> If we are to isolate as an independently reviewable question of law the view of the Tax Court that money consideration must benefit the donor to

[4] Note that Spouse's transfers on the same date as Agreement to Children's Trusts are independent of Agreement. Paragraph 5 of Agreement acknowledges that Agreement "contains the entire agreement and understanding among the parties hereto with respect to the subject matter hereof."

> relieve a transfer by him from being a gift, we think the Tax Court was correct. . . . The section taxing as gifts transfers that are not made for "adequate and full (money) consideration" aims to reach those transfers which are withdrawn from the donor's estate.

Wemyss, 324 U.S. at 307-08. In other words, valuable contractual consideration in the hands of the donor is not sufficient; adequate and full consideration is that which replenishes, or augments, the donor's taxable estate.

In *Merrill,* the donor transferred property to donor's then spouse in exchange for spouse's relinquishment of marital rights in donor's remaining property. The Court held that spouse's relinquishment of the marital rights did not constitute adequate and full consideration for donor's transfer because the assets subject to the marital rights were already includible in donor's gross estate. *Id*. at 312-13.

Rev. Rul. 69-505, 1969-2 C.B. 179, involves a transfer to a trust of joint-tenancy property that is treated as a reciprocal exchange for consideration in money or money's worth. A and B owned the property as joint tenants and could each unilaterally sever the joint tenancy, and if not severed, the property would pass to the survivor upon the death of the other joint tenant. A and B transferred the property to a trust, reserving the right to receive one-half of the income therefrom for their joint lives and all to the survivor for life with remainder to C. Citing § 25.2511-1(e) and *U.S. v. Estate of Grace*, 395 U.S. 316 (1969), the revenue ruling holds that the transfers between A and B are treated as a reciprocal exchange for consideration in money or money's worth. Thus, neither A nor B made a gift to the other to the extent that the transfers were of equal value. The revenue ruling concludes that since the value of the gift by B is less than the value of the gift by A, A is deemed to have made a gift to B of the difference in value of A's and B's transfer.

Estate of Grace is the seminal case on the reciprocal trust doctrine. The reciprocal trust doctrine uncrosses transfers of property in trust that were made pursuant to an interrelated scheme and that resulted, to the extent of like values involved, in leaving the settlors in approximately the same economic position they would have otherwise been in had they not engaged in the transaction.

Here, Paragraph 3 of Agreement provides that the "deemed gift of the remainder interest" under § 2519(a) and the gift from Children to Spouse under § 2511 result in a "reciprocal gift transfer." This statement in Agreement is not supported by the economics of the transaction or the gift tax meaning of what constitutes "adequate and full consideration."

Agreement characterized the transaction as a commutation of Trust 1 followed by a distribution of all trust property to Spouse. Thus, Spouse agrees to the extinguishment of Spouse's lifetime interest in Trust 1 and Children agree to the extinguishment of their remainder interest in Trust 1 in exchange for receipt of their respective proportionate

share of trust property. Also pursuant to Agreement, Children transfer their proportionate share of trust property received in the commutation to Spouse and receive no consideration from Spouse in exchange for the transfer. Absent entering into Agreement, Spouse had no right to the remainder under the terms of Trust 1 or otherwise. Therefore, from an economic perspective, the transaction resulted in a one-sided gift transfer from Children to Spouse.

It is the deemed gift transfer arising by application of § 2519(a) that is the crux of Spouse and Children's position, as stated in Agreement, that the transfers are reciprocal gift transfers. However, unlike in Rev. Rul. 69-505, Spouse's deemed transfer under § 2519(a) and Children's transfers of their remainder interests under § 2511 do not constitute offsetting exchanges of consideration. Spouse received no consideration for the deemed transfer to Children under § 2519(a). That is, because the entire value of Trust 1 was subject to inclusion in Spouse's gross estate under § 2044, the transfer of the remainder by Children to Spouse does not augment Spouse's estate and, thus, cannot constitute the receipt of adequate and full consideration for gift tax purposes. *See Commissioner v. Wemyss; Merrill v. Fahs.*

The fact that Spouse can receive no consideration for the deemed transfer resulting from the application of § 2519(a) does not nullify Children's transfers of their remainder interests in Trust 1. When Trust 1 was commuted, the remainder interest vested outright, equally in Children, the then remaindermen. Children then transferred their valuable property interest to Spouse and received nothing in exchange. Under § 2512(b) and *Wemyss*, these transfers by Children for no consideration constitute a gift. If Children were to transfer their remainder interests to a third party other than Spouse, the transfers would clearly be a gift. The result is the same if the donee is the surviving spouse beneficiary of a QTIP trust.[5] Thus, the transaction cannot be considered involving offsetting transfers for consideration within the meaning of Rev. Rul. 69-505.

Likewise, the facts here do not support the application of the reciprocal trust doctrine enunciated in *Estate of Grace*, without regard to consideration. After entering into Agreement, Spouse and Children are not in approximately the same economic position they would have otherwise been absent entering into Agreement (i.e., Children no longer have a beneficial interest in Trust 1 and Spouse then holds the trust property outright, including the actuarial value of the remainder interest).

QTIP Statutory Scheme and Legislative History

The foregoing analysis is consistent with the QTIP statutory regime, the legislative

[5] The gift tax consequences to remainder beneficiaries of a QTIP trust in a § 2519(a) disposition where all of the trust property is distributed to the surviving spouse is also discussed in PLR 199908033, which was referenced in *Estate of Kite v. Commissioner*, T.C. Memo. 2013-43. Note that PLRs may not be cited as precedent.

history, the rulings and the caselaw analyzing the issue of consideration in the context of deemed dispositions under § 2519(a).

Section 2056(a) provides that the value of the taxable estate shall, except as limited by § 2056(b), 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 in relevant part that no deduction shall be allowed for an interest passing to the surviving spouse where the interest will terminate or fail, and on such termination, the property passes to a person other than the surviving spouse or the spouse's estate.

Section 2056(b)(7) provides an exception to the "terminable interest" rule in § 2056(b)(1) and allows a deduction in the case of QTIP. Under § 2056(b)(7)(A), QTIP is treated as passing to the surviving spouse for purposes of § 2056(a), and no part of the property is treated as passing to any person other than the surviving spouse for purposes of § 2056(b)(1).

Under § 2056(b)(7)(B)(i), the term "qualified terminable interest property" generally refers to property in which the spouse receives a qualifying income interest for life, and with respect to which the executor makes an election to treat the property as QTIP.

Section 2044(a) provides that the value of the gross estate includes the value of any property described in § 2044(b) in which the decedent had a qualifying income interest for life. Section 2044(b) provides that § 2044(a) applies to any property if a deduction was allowed with respect to the transfer of the property to the decedent under § 2056(b)(7), and § 2519 did not apply with respect to a disposition by the decedent of part or all of such property.

The QTIP provisions (§§ 2056(b)(7), 2044, and 2519) were enacted in 1981, at the same time as the unlimited marital deduction. See § 403(d) of the Economic Recovery Tax Act of 1981 (ERTA), Pub. Law 97-34, 95 Stat. 172, 302-05 (August 13, 1981). Section 2056(b)(7) was enacted to provide an alternative to an outright transfer of property to the surviving spouse that would qualify for the unlimited marital deduction. *See* H. REP. NO. 97-201, at 159-60 (1981). Given that an income interest that terminates at death generally is not includible in a decedent's gross estate, §§ 2044 and 2519 were added to ensure that the transfer tax deferred by § 2056(b)(7) becomes subject to tax, either on the surviving spouse's death or after a lifetime disposition of spouse's qualifying income interest. *See* H. REP. NO. 97-201, at 161-62. Thus, the QTIP statutory scheme is consistent with the policy underlying the marital deduction, that is, to allow property to pass to the surviving spouse without the decedent-spouse's estate paying tax on its value, but only until such time as the surviving spouse either dies or makes a lifetime disposition of the property. Under either circumstance, the transfer tax is ultimately paid. *See, e.g., U.S. v. Stapf*, 375 U.S. 118, 128 (1963).

In Rev. Rul. 98-8, 1998-1 C.B. 541, the surviving spouse purchased from the trust remainderman the remainder interest in a QTIP trust by issuing a promissory note equal to the actuarial value of the remainder interest to the remainderman. As a result of the purchase, the trust terminated under its terms and the entire corpus was transferred to the surviving spouse. The surviving spouse then used the proceeds to pay the remainderman the value of the remainder interest. The revenue ruling concludes that the purchase of the remainder interest, which is analogous to a commutation of the QTIP trust, is treated as a taxable disposition by the surviving spouse of the qualifying income interest, resulting in a gift of the value of the remainder interest under § 2519. Citing to *Wemyss*, the revenue ruling explains that the receipt of the remainder interest cannot increase the donor's taxable estate because it is already subject to inclusion in the surviving spouse's taxable estate under § 2044. Accordingly, the surviving spouse's receipt of the remainder interest cannot constitute adequate and full consideration under § 2512 for the promissory note transferred. The revenue ruling notes that any other result would subvert the legislative intent and statutory scheme underlying § 2056(b)(7).

In *Estate of Kite v. Commissioner*, T.C. Memo. 2013-43, the surviving spouse was the beneficiary of two QTIP trusts. According to a prearranged plan, the QTIP trusts were terminated and all assets were distributed to the surviving spouse. Two days later, the surviving spouse sold the assets to her three children in exchange for three deferred private annuity agreements under which payments would commence ten years thereafter. In the event that the surviving spouse died within the ten-year period, her annuity interest would terminate and nothing would be payable to her estate. Based on the facts and circumstances, the court found the sale of the assets of the QTIP trusts to the children in exchange for deferred annuities constituted a bona fide sale for adequate and full consideration and treated the annuity transaction as a single integrated transaction for purposes of § 2519. Moreover, the sale of the assets of the QTIP trusts, followed by the payment to the surviving spouse of the proceeds equal to the value of her income interest, was a disposition of her qualifying income interest for purposes of § 2519. In response to petitioner's post-opinion argument that there was no gift tax deficiency for the § 2519 disposition of the surviving spouse's qualifying income interest based on the receipt of full and adequate consideration, the court stated,

> [S]ection 2519(a) treats the disposition of a qualifying income interest as a deemed transfer of the remainder interest. In other words, "the donee spouse is treated as making a gift under section 2519 of the entire trust less the qualifying income interest" (emphasis added). Sec. 25.2519-1(a), Gift Tax Regs. The term "gift" is not an accident. The remainder interest is a future interest held by the remainderman and not the donee spouse. Accordingly, the donee spouse cannot receive full and adequate consideration, or indeed any consideration, in exchange for the remainder interest. This result is supported by the intent of the marital deduction and the QTIP regime.

Estate of Kite v. Commissioner, No. 6772-08 (T.C. Oct. 25, 2013) (order and decision under Tax Court Rule 155). The court ruled that the decedent owed gift tax on the value of the deemed § 2519 gift. *Id*.

Here, the QTIP statutory scheme and legislative history support the view that Rev. Rul. 69-505 has no application and the separate transfers by Spouse and Children cannot be offset by consideration for gift tax purposes. Decedent's estate received the benefit of deferral of the estate tax liability allocable to the property of Trust 1 as a result of electing QTIP for such property under § 2056(b)(7). Because the commutation effected by Agreement constitutes a taxable disposition by Spouse within the meaning of § 2519(a) (see Issue 1), it marks the end of the deferral of the tax.

Rev. Rul. 98-8 and *Estate of Kite* illustrate that a disposition under § 2519(a) has significant tax consequences, which are appropriate in view of the QTIP statutory scheme and legislative history. Here, because the commutation of Trust 1 results in a disposition of Spouse's qualifying income interest within the meaning of § 2519(a), Spouse is treated as effectively transferring the remainder interest even though under state property law precepts the remainder interest is held by Children, not Spouse. The taxable transfer by Spouse resulting from the application of § 2519 marks the end of the deferral of estate tax on the Trust 1 property that passed untaxed from Decedent's estate, and is no longer subject to inclusion in Spouse's gross estate under § 2044(b)(2). Eliminating the taxable transfer by Spouse based on a deemed reciprocal gift transfer by the remaindermen would allow the value of the remainder of Trust 1 to escape transfer tax under both §§ 2519 and 2044, which would be contrary to the QTIP statutory scheme and legislative history.

Based on all of the above, we conclude that the commutation of Trust 1 and the distribution of all trust property to Spouse results in separate gift transfers by Children under § 2511 and by Spouse under § 2519(a) that do not offset each other.

ISSUE 4: Value of Spouse's Gift under § 2519(a)

Although the deemed gift under § 2519 is often referred to as a gift of the remainder interest, implying that the amount of the gift is the fair market value of the remainder interest, § 2519(a) and § 25.2519-1(a) take a different approach. Section 2519(a) and § 25.2519-1(a) and (c)(1) apply the subtractive method of valuation; the amount treated as a gift by the surviving spouse is the fair market value of all interests in the property less the value of the qualifying income interest.

A qualifying income interest is defined as the right to receive "all of the income from the entire interest." Section 20.2056(b)-7(d)(2) cross-referencing § 20.2056(b)-5(f).

Section 25.2512-5(a) generally provides that except as otherwise provided in §§ 25.2512-5(b) and 25.7520-3(b) of the Procedure and Administration Regulations, the fair market value of annuities, unitrust interests, life estates, term of years, remainders,

and reversions transferred by gift, is the present value of the interests determined under § 25.2512-5(d).

Section 25.2512-5(d)(1) provides that the fair market value of annuities, life estates, terms of years, remainders, and reversions transferred on or after May 1, 2009, is the present value of such interests determined under § 25.2512-5(d)(2) and by use of standard or special § 7520 actuarial factors.

Section 25.2512-5(d)(2)(iii) provides generally that if the interest to be valued is the right of a person to receive the income of certain property, or to use certain non-income-producing property, for the life of one individual, the present value of the interest is computed by multiplying the value of the property by the appropriate life interest actuarial factor (that corresponds to the applicable § 7520 interest rate and life interest period).

Section 25.7520-1(a)(1) provides that except as otherwise provided in §§ 25.7520-1 and 25.7520-3(b), in the case of gifts made after April 30, 1989, the fair market value of annuities, interests for life or for a term of years, remainders, and reversions is their present value determined under § 25.7520-1. Section 25.7520-1(b) provides generally that valuation under § 7520 consists of an interest rate component and a mortality component. For gifts made on or after May 1, 2009, the mortality component table is contained in § 20.2031-7(d)(7).

Section 25.2519-1(c)(4) provides that the amount treated as a transfer under § 25.2519-1(c)(1) is further reduced by the amount the surviving spouse is entitled to recover under § 2207A(b) (relating to the right to recover gift tax attributable to the remainder interest). Under § 25.2519-1(c)(4), if the donee spouse is entitled to recover gift tax under § 2207A(b), the amount of the gift tax recoverable and the value of the interest treated as transferred under § 2519 are determined by using the same interrelated computation applicable for other transfers in which the transferee assumes the gift tax liability. The gift tax consequences of failing to exercise the right of recovery are determined separately under § 25.2207A-1(b).

Under § 2207A(b) and § 25.2207A-1(a), a surviving spouse treated as transferring an interest in property by reason of § 2519 is entitled to recover from the "person receiving the property" the amount of gift tax attributable to that property. The right of recovery arises at the time the gift tax is actually paid by the surviving spouse subject to § 2519.

In this case, the amount of Spouse's gift under § 2519 is determined by subtracting the value of Spouse's qualifying income interest from the fair market value of the trust property as of Date 3, the date of Agreement. Section 2519(a); § 25.2519-1(a). Discretionary principal distributions and the testamentary limited power of appointment are not taken into account. A standard § 7520 income factor can be used to value the qualifying income interest, and thus, the value of Spouse's qualifying income interest is determined by multiplying the value of the trust property by the income factor of

0.09172.[6] Section 25.2512-5(d)(2)(iii); § 25.7520-1. Based on a value of the trust property of $b, the value of Spouse's qualifying income interest is $e. The amount of Spouse's gift under § 2519, therefore, is $f (i.e., $b – $e = $f).

To the extent Spouse is entitled to recover gift tax attributable to the remainder interest under § 2207A(b), this amount is reduced, using an interrelated calculation. Note that, under § 25.2207A-1(b), if Spouse waives or otherwise fails to exercise Spouse's right of recovery, Spouse will be treated as making an additional gift in the amount of the unrecovered tax.[7]

ISSUE 5: Value of Children's Gifts of Remainder Under § 2511

Section 2512(a) provides that if a gift is made in property, the value at the date of the gift shall be considered the amount of the gift.

Section 25.2512-5(d)(2)(ii) provides in relevant part, that if the interest to be valued is to take effect after the death of one individual, the present value of the interest is computed by multiplying the value of the property by the appropriate remainder interest actuarial factor (that corresponds to the applicable § 7520 interest rate and remainder interest period).

Section 25.7520-3(b) provides exceptions to the use of the standard actuarial factors.

Section 25.7520-3(b)(1)(ii) provides that, in general, a standard § 7520 annuity, income, or remainder factor may not be used to value a restricted beneficial interest. A "restricted beneficial interest" is an annuity, income, remainder, or reversionary interest that is subject to any contingency, power, or other restriction, whether the restriction is provided for by the terms of the trust, will, or other governing instrument or is caused by other circumstances.

Section 25.7520-3(b)(2)(iii) provides in relevant part, that a standard § 7520 remainder factor may not be used to determine the present value of a remainder interest (whether in trust or otherwise) unless, consistent with the preservation and protection that the law of trusts would provide for a person who is unqualifiedly designated as the remainder beneficiary of a trust, the effect of the administrative and dispositive provisions for the interest that precedes the remainder interest is to assure that the property will be adequately preserved and protected (e.g., from erosion, invasion, depletion, or damage) until the remainder interest takes effect in possession and enjoyment.

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[6] The income factor of 0.09172 is determined as follows: 1.000000 minus 0.90828, the § 20.2031-7(d)(7), Table S remainder factor at age y and z%, the § 7520 rate on Date 3.

[7] The request for advice raises the possibility that Paragraph 5 of Agreement may constitute a written waiver of Spouse's right of recovery under state law. To the extent it does, the gift tax consequences of failing to exercise the right of recovery are determined separately under § 25.2207A-1(b) and do not factor into the computation of the amount of the gift under § 2519.

Section 25.7520-3(b)(1)(iii) provides that if the § 7520 interest rate and mortality components are not applicable in determining the value of any annuity, income, remainder, or reversionary interest, the actual fair market value of the interest (determined without regard to § 7520) is based on all of the facts and circumstances.

Where a standard § 7520 annuity, income, or remainder factor may not be used, the actual fair market value of the interest has been determined in some instances by an actuarial determination of the present value of the interest adjusted to account for the restriction. In *Estate of Gokey v. Commissioner*, T.C. Memo 1984-665, the Tax Court determined that principal invasion for the care, comfort, support or welfare of the life interest beneficiary was likely and discounted the present value of the remainder interest accordingly, explaining "where an ascertainable standard exists, the [taxpayer] must establish with reasonable certainty the needs of the owner of the life estate for the rest of her life and the extent to which corpus might be invaded under the standard." *Id.* (citing *Lockard v. Commissioner*, 7 T.C. 1151, 1154-55 (1946), ***aff'd,*** 166 F. 2d 409 (1st Cir. 1948)). *See also Ithaca Trust Co. v. U.S.*, 279 U.S. 151, 154 (1929) (determining that the value of a charitable remainder interest could be derived from IRS mortality tables with no diminution in value to account for principal invasion subject to a standard for the beneficiary of the life interest because income was more than enough to satisfy the standard, making principal invasion highly unlikely).

In this case, the interests to be valued are the Children's respective remainder interests in Trust 1, determined as of Date 3. While Agreement acknowledges a commutation occurred, the terms of Agreement indicate that no computation of the value of the commuted interests in Trust 1 was performed by the trustee since all property was distributed to Spouse. Further, Child 1 and Child 2 each reported the gift of their proportionate share of the remainder interest to Spouse on Forms 709, but each reported the amount of the gift to be $0. In the absence of the trustee's or Children's computations of the actuarial value of Children's respective remainder interests in Trust 1, the Service will make its own determination.

Based on the available facts, it is appropriate to value each of Children's interests as one-half of the actuarial present value of the remainder interest, adjusting as necessary for the restrictions on the beneficial interests. The determination takes into account that the possibility of principal invasion was so remote as to be negligible, given that the combined value of the property held by Trust 1 was $b at the time of commutation and, thus, annual income of Trust 1 would have been substantial and likely sufficient for Spouse's health, maintenance, and support, even if Spouse's accustomed manner of living were extravagant.[8] Further, the determination takes into account, based on all the facts and circumstances, that the testamentary limited power of appointment would be appropriately treated as having no measurable effect on the values of these interests.

[8] This reasoning is bolstered by Spouse's sale of most of the trust property immediately after Spouse received it in exchange for promissory notes that did not provide for the payment of principal until a date after Spouse's probable life expectancy.

Accordingly, based on the available facts, we conclude that the actuarial value of Children's proportionate shares of the remainder interest is properly determined under § 7520, using a standard remainder factor. Thus, the value of each child's remainder interest under § 7520 is determined by multiplying the value of the trust property by the remainder factor of 0.90828[9] then dividing the product by 2. Section 25.2512-5(d)(2)(ii); § 25.7520-1. Based on a value of the trust property of $b, the fair market value of each child's gift, therefore, is $g (i.e., ($b x 0.90828) ÷ 2 = $g).

Please call (202) 317-6859 if you have any further questions.

[9] The remainder factor of 0.90828 is the § 20.2031-7(d)(7) Table S remainder factor at age y and z%, the § 7520 rate on Date 3.