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# THE QUALIFIED TERMINABLE PROPERTY TRUST: SHOULD PROPOSED REGULATIONS BE FOLLOWED?

*Estate of Howard v. Commissioner*<sup>1</sup>

## INTRODUCTION

In 1916 Congress enacted what is known today as the federal estate tax.<sup>2</sup> This tax is imposed on the taxable estate of every decedent who is a citizen or resident of the United States.<sup>3</sup> To compute the "taxable estate," the personal representative must first determine the decedent's gross estate, which is defined as "the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated."<sup>4</sup> The executor must deduct the following from the gross estate: (1) administrative expenses of the estate,<sup>5</sup> (2) losses incurred during the administration of the estate,<sup>6</sup> (3) charitable deductions,<sup>7</sup> and (4) bequests to the surviving spouse (the marital deduction).<sup>8</sup> The balance remaining is the value of the taxable estate.<sup>9</sup>

It is important to the administration of an estate, and also in pre-death estate planning, that the deductions outlined above are applied prop-

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1. 91 T.C. 329 (1988).

2. Pub. L. No. 64-271, 39 Stat. 756 (1916). This tax was held to be constitutional in *New York Trust Co. v. Eisner*, 256 U.S. 345, 348 (1921).

3. 26 U.S.C. § 2001(a) (1986). All references are to the Internal Revenue Code (IRC) of 1986 unless otherwise noted.

4. 26 U.S.C. § 2031(a) (1986). With respect to the time of valuation, the executor may elect to value the gross estate using the alternate valuation date which is either: (1) the value of the assets six months after the decedent's death, or (2) if sold, distributed or otherwise disposed of prior to the six month date, the value shall be the value on the date of actual disposition. 26 U.S.C. § 2032(a)(1), (2) (1986).

5. 26 U.S.C. § 2053 (1986).

6. 26 U.S.C. § 2054 (1986).

7. 26 U.S.C. § 2055 (1986).

8. 26 U.S.C. § 2056 (1986). See *infra* text accompanying note 24 for explanation of the marital deduction.

9. 26 U.S.C. § 2051 (1986).

erly and taken into account in the estate planning process. The result is optimum estate tax treatment. This Note will look at the marital deduction and, in particular, the application and the benefits of the qualified terminable interest property (QTIP) provision<sup>10</sup> after *Estate of Howard v. Commissioner*.<sup>11</sup>

#### LEGAL BACKGROUND

The marital deduction<sup>12</sup> was first introduced in the Revenue Act of 1948.<sup>13</sup> In *United States v. Stapp*,<sup>14</sup> the United States Supreme Court explained the general purpose of this legislation:

The 1948 tax amendments were intended to equalize the effect of the estate taxes in community property and common-law jurisdictions. Under a community property system . . . the spouse receives outright ownership of one-half of the community property and only the other one-half is included in the decedent's estate. To equalize the incidence of progressively scaled estate taxes and to adhere to the patterns of state law, the marital deduction permits a deceased spouse, subject to certain requirements, to transfer free of taxes one-half of the non-community property to the surviving spouse. Although applicable to separately held property in a community property state, the primary thrust of this is to extend to taxpayers in common-law States the advantages of "estate splitting" otherwise available only in community property States.<sup>15</sup>

In 1976, the marital deduction was amended to allow a deduction for fifty percent of an estate or \$250,000, whichever is greater. This gave small estates an unlimited deduction.<sup>16</sup> The Economic Recovery Act of 1981 expanded the marital deduction to an unlimited deduction,<sup>17</sup> thereby chang-

10. 26 U.S.C. § 2056(b)(7) (1986).

11. 91 T.C. 329 (1988).

12. 26 U.S.C. § 2056 (1986). Bequests, etc., to surviving spouse  
(a) Allowance of marital deduction.—For purposes of the tax imposed by section 2001, the value of the taxable estate shall, except as limited by subsection (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.

*Id.*

13. The Revenue Act of 1948, Pub. L. No. 80-471, §§ 361, 372, 62 Stat. 110, 117-21, 125-27 (1948).

14. 375 U.S. 118 (1963).

15. *Id.* at 128 (footnote omitted); see also H.R. REP. NO. 1274, 80th Cong., 2d Sess. 24-26, reprinted in 1948 U.S. CODE CONG. & ADMIN. NEWS 1270-72; S. REP. NO. 1013, 80th Cong., 2d Sess. 26-29, reprinted in 1948 U.S. CODE CONG. & ADMIN. NEWS 1189-91.

16. The Tax Reform Act of 1976, Pub. L. No. 94-455, § 2002, 90 Stat. 1520, 1854 (1976).

17. The Economic Recovery Act of 1981, Pub. L. No. 97-34, § 403, 95

ing the purpose of the marital deduction from a policy of equal tax treatment between states to treating the married couple as a single tax unit for estate tax purposes.<sup>18</sup>

The practical effect of the marital deduction is that a married couple can defer all or part of the estate taxes on the taxable estate of a deceased spouse until the death of the surviving spouse.<sup>19</sup> The deferral of estate tax payments has several benefits. First, it can reduce or eliminate any liquidity problems in the first estate by enabling the surviving spouse to retain valuable assets rather than selling them to pay the estate taxes.<sup>20</sup> Second, the tax savings may be reinvested to earn additional income and the retained property can continue to appreciate in value.<sup>21</sup> Also, the property will have a new tax basis equal to the fair market value at the time the second spouse dies, not at the death of the first spouse.<sup>22</sup>

The marital deduction allows a deduction in the estate of the deceased spouse for the full value of property interests that pass to the surviving spouse.<sup>23</sup> This deduction allows a married couple to be treated as a single tax unit for estate and gift tax purposes by providing the mechanism to shift assets from one estate to the other. Property may pass from decedent to surviving spouse by any means, testamentary or otherwise.<sup>24</sup> However, a terminable property interest that is passed to the surviving spouse is not eligible for the marital deduction.<sup>25</sup>

The "terminable interest rule"<sup>26</sup> was created to assure that property excluded from the taxable estate of the decedent because it was bequeathed to the surviving spouse would be taxed at the surviving spouse's death.<sup>27</sup>

18. Abrams, *A Reevaluation of the Terminable Interest Rule*, 39 TAX L. REV. 1, 12 (1983); see also S. REP. NO. 144, 97th Cong., 1st Sess. 127, reprinted in 1981 U.S. CODE CONG. & ADMIN. NEWS 228-29.

19. Northeastern Pa. Nat'l Bank & Trust Co. v. United States, 363 F.2d 476, 479-80 (3d Cir. 1966), rev'd on other grounds, 387 U.S. 213 (1967).

20. *Estate Tax Marital Deduction*, Tax Mgmt. 3d (BNA) No. 239, at A-68 (July 18, 1988).

21. *Id.* This benefit could be significant if the time between the death of the spouses is substantial.

22. *Id.*

23. 26 U.S.C. § 2056(b)(7)(A)(ii) (1986).

24. *Dodd v. United States*, 223 F. Supp. 785, 787 (D.N.J. 1963), *aff'd*, 345 F.2d 715 (3d Cir. 1965).

25. 26 U.S.C. § 2056(b) (1986).

26. 26 U.S.C. § 2056(b) (1986). The relevant part reads:

Limitation in the case of life estate or other terminable interest.—

(1) General rule.—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- . . . .

*Id.*

27. *Dougherty v. United States*, 292 F.2d 331, 337 (6th Cir. 1961); see also *In re Estate of Reilly*, 239 F.2d 797, 799 (3d Cir. 1957).

Without the terminable interest requirement, anyone could entirely evade the federal estate tax.<sup>28</sup>

A property interest is a terminable interest when the following characteristics are met:

- (1) the interest must be capable at the time of the decedent's death of terminating "upon the occurrence or non-occurrence of an event or upon the lapse of time;"
- (2) the decedent must pass or have passed to third party(s) another interest in the property for less than adequate consideration in money or money's worth; and
- (3) the party(s) must be able to possess or enjoy a part of such property upon the termination of the surviving spouse's interest.<sup>29</sup>

Therefore, a husband could not pass to his wife a legal life estate in his property with a remainder to his children because (1) the wife's interest terminates at death; (2) the children are passed an interest in the corpus for less than adequate consideration; and (3) the children can enjoy the property upon the spouse's death.

When the marital deduction was originally enacted the terminable interest rule contained three exceptions: (1) the survivorship exception;<sup>30</sup> (2) the life insurance and annuity exception;<sup>31</sup> and (3) a life estate with a general power of appointment exception.<sup>32</sup>

In addition to eliminating the ceiling on the marital deduction, the Economic Recovery Act of 1981 also created another exception to the terminable interest rule.<sup>33</sup> This exception creates a marital deduction for

28. *Allen v. United States*, 359 F.2d 151, 154 (2d Cir.), *cert. denied*, 385 U.S. 832 (1966).

29. *Id.*

30. 26 U.S.C. § 2056(b)(3) (1986).

31. 26 U.S.C. § 2056(b)(6) (1986).

32. 26 U.S.C. § 2056(b)(5) (1986).

33. Economic Recovery Act of 1981, Pub. L. No. 97-34, § 403(d)(1) (codified at 26 U.S.C. § 2056(b)(7) (1986)) which reads:

- (A) In general.—In the case of qualified terminable interest property—
  - (i) for purposes of subsection (a), such property shall be treated as passing to the surviving spouse, and
  - (ii) for purposes of paragraph (1)(A), no part of such property shall be treated as passing to any person other than the surviving spouse.
- (B) Qualified terminable interest property defined.—For purposes of this paragraph—
  - (i) In general.—The term "qualified terminable interest property" means property—
    - (I) which passes from the decedent,
    - (II) in which the surviving spouse has a qualifying income interest for life, and
    - (III) to which an election under this paragraph applies.
  - (ii) Qualifying income interest for life.—The surviving spouse has a

property, or an interest in property, which passes to the spouse from the decedent. For the exception to apply, the spouse must have a qualifying income interest for life in the property and the personal representative of the decedent must affirmatively elect to designate the property as QTIP property.<sup>34</sup>

The terminable interest exception was added to liberalize the application of the marital deduction to allow married taxpayers to benefit both the spouse and children.<sup>35</sup> The House committee report states that

unless certain interests which do not grant the [surviving] spouse control are eligible for the unlimited marital deduction, a decedent would be forced to choose between surrendering control of the entire estate to avoid imposition of estate tax at his death or reducing his tax benefits at his death to insure inheritance by the children. The committee believes that the tax laws should be neutral and that tax consequences should not control an individual's disposition of property.<sup>36</sup>

Under this provision as enacted, the grant of a legal life estate to the surviving spouse with a remainder in the property would now be entitled to the marital deduction. This is particularly advantageous in the case of married couples with children from previous marriages. It assures that the decedent can provide for both the surviving spouse and the children without worrying about the tax consequences. In addition, a major advantage is the availability of the QTIP exception by an election after the death of the first spouse. This factor allows for some post-mortem estate planning.<sup>37</sup> The marital deduction, on the other hand, must be planned in advance, since it is automatic and cannot be waived.<sup>38</sup>

For an estate to be eligible to make the QTIP election, the decedent must pass to the spouse property in which the spouse has a qualifying income interest for life.<sup>39</sup> The surviving spouse is deemed to have acquired a "qualifying income for life" if:

- (1) 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

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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.

26 U.S.C. § 2056(b)(7)(A), (B) (1986).

34. 26 U.S.C. § 2056(b)(7) (1986).

35. H.R. REP. NO. 201, 97th Cong., 1st Sess. 160 (1981).

36. *Id.*

37. *Estate Tax Marital Deduction*, Tax Mgmt. 3d (BNA) No. 239, at A-69 (July 18, 1988).

38. Rev. Rul. 59-123, 1959-1 C.B. 248.

39. 26 U.S.C. § 2056(b)(7) (1986).

(2) no person has a power to appoint any part of the property to any person other than the surviving spouse.<sup>40</sup>

If the requirements are met and the personal representative makes a timely election,<sup>41</sup> the QTIP provision allows the personal representative to deduct the full value of the property involved from the gross estate and not just the surviving spouse's interest in the life estate.<sup>42</sup> Therefore, in essence, the QTIP provision allows a decedent to make two gifts and to defer the tax on both until a later date.<sup>43</sup> On the death of the surviving spouse or when the surviving spouse disposes of the qualified income interest, the property is taxed.<sup>44</sup> The tax is determined by aggregating the value of the QTIP property with either their cumulative lifetime gifts or the surviving spouse's estate.<sup>45</sup> Because the beneficiaries of the surviving spouse and the remaindermen under the QTIP trust might not be the same, the surviving spouse's estate has the right to seek reimbursement from the remainderman. This enables the tax on the QTIP property to be properly allocated to those who receive it.<sup>46</sup>

#### ESTATE OF HOWARD

In *Estate of Howard v. Commissioner*<sup>47</sup> the Tax Court found that part of the proposed Internal Revenue Service (IRS) regulations with respect to the QTIP deduction did not comply with the intent of the statute. The petitioner in the subject case, the Estate of Rose D. Howard, had filed an estate tax return on November 13, 1984.<sup>48</sup> This return did not include the value of trust assets of a trust which she and her deceased husband, Volney E. Howard, Jr. (Howard), had established.<sup>49</sup>

40. 26 U.S.C. § 2056(b)(7)(B)(ii) (1986).

41. An election under this paragraph with respect to any property shall be made on the federal estate tax return. Once made this election is irrevocable. 26 U.S.C. § 2056(b)(7)(B)(v) (1986).

42. 26 U.S.C. § 2056(b)(7)(A)(ii) (1986).

43. 26 U.S.C. § 2056(a) (1986).

44. 26 U.S.C. § 2044 (1986). Section 2044 provides:  
Certain property for which marital deduction was previously allowed.

(a) General rule.—The value of the gross estate shall include the value of any property to which this section applies in which the decedent had a qualifying income interest for life.

(b) Property to which this section applies.—This section applies to any property if—

(1) a deduction was allowed with respect to the transfer of such property to the decedent—

(A) under section 2056 by reason of (b)(7) thereof, or

(B) under section 2523 by reason of subsection (f) thereof.

45. 26 U.S.C. §§ 2044, 2519 (1986).

46. 26 U.S.C. § 2207A (1986).

47. 91 T.C. 329 (1988).

48. *Id.* at 331.

49. *Id.* at 330.

Howard died on April 24, 1983 and included in his gross estate was the value of the trust assets.<sup>50</sup> The executors of Howard's estate elected to treat the trust as a QTIP trust and deducted the value of the trust as a marital deduction.<sup>51</sup> The trust instrument provided that the income was to be paid to Rose quarterly or at more frequent intervals. In addition, it specifically stated: "Income accrued or held undistributed by the trustee at the termination of any interest shall go to the next beneficiaries of the trust in proportion to their interests in the trust."<sup>52</sup> On July 3, 1984, Howard's estate filed with the IRS an amended federal estate tax return. The return stated that the trust was not a QTIP trust because of the provision for accumulated and undistributed income to pass outside of the surviving spouse's estate. Therefore, Howard's estate was not entitled to make a QTIP election and the trust did not otherwise fulfill the requirements of the marital deduction.<sup>53</sup> The additional tax due was paid with the amended return.<sup>54</sup>

The IRS argued that, once Howard's estate elected to take the QTIP election, the value of the QTIP property was includable in the gross estate of Rose, the surviving spouse.<sup>55</sup> In addition, the IRS argued there is no requirement that the accumulated but undistributed income pass to the decedent's estate; and, that the phrase "payable annually or at more frequent intervals," found in the statute, limits the phrase "all income".<sup>56</sup> The Tax Court held for the petitioner, holding that, to satisfy the requirements of a QTIP trust:

the income accumulated by the trust between the last date of distribution and the surviving spouse's death must be disposed of as the surviving spouse directs either by virtue of being payable to the surviving spouse's estate, or through a power of appointment which includes a power to appoint to her estate or to such other persons as she may direct.<sup>57</sup>

Because of the holding in *Estate of Howard*,<sup>58</sup> many estate planning documents lose a valuable estate planning tool where the language in question is present or where the operation of law produces the same result.

In *Howard*, the Tax Court confronted the issue of interpreting the phrase "entitled to all the income from the property, payable annually" under 26 U.S.C. section 2056(b)(7)(B)(ii)(I). The court also had to decide whether the language of the Howard trust met the statutory requirements.

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50. *Id.*

51. *Id.*

52. *Id.* at 330-31.

53. *Id.* at 331.

54. *Id.*

55. *Id.* at 337.

56. *Id.* at 335.

57. *Id.* at 338 (footnote omitted).

58. *Id.* at 330.



The trust agreement provided that Rose was to be paid, quarterly or more frequently, the income generated by the trust.<sup>59</sup> However, at her death, the trust provided that any accumulated but undistributed income passed to the next beneficiaries.<sup>60</sup>

The IRS first dealt with this issue in a number of private letter rulings in 1984.<sup>61</sup> In the private letter rulings the IRS held that a "trust requiring distribution of entire net income to surviving spouse at least monthly, gave spouse qualifying income interest even though undistributed income accruing between last distribution date and surviving spouse's death wasn't payable to spouse or her estate."<sup>62</sup> The IRS' rationale was based on the theory that the income, while not given to the spouse's estate, would still be required to be included in the spouse's gross estate so that estate tax would be paid as required by section 2044.<sup>63</sup> However, this explanation is faulty for two reasons. First, section 2044 requires the inclusion in a decedent's estate of all property in which the decedent has a qualifying income interest for life.<sup>64</sup> However, after the decision in *Estate of Howard*, there is no qualifying income interest for life under these circumstances. Therefore, the trust does not qualify as a QTIP trust, and section 2044 cannot come into play. The IRS was attempting to answer the question by applying the result. Second, under section 691(a) the spouse's estate has no income tax responsibility for this income since this income is taxable to the beneficiaries who receive it.<sup>65</sup>

In May, 1984, the IRS issued proposed regulations concerning section 2056(b)(7)<sup>66</sup> which were in line with the determinations in the private letter rulings.<sup>67</sup> The proposed regulations stated that "an income interest will not fail to constitute a qualifying income interest for life solely because income between the last distribution date and the date of the surviving spouse's death is not required to be distributed to the surviving spouse or the surviving spouse's estate."<sup>68</sup> In making this decision, the IRS cross-referenced section 2044 to support the subject language in the proposed re-

59. *Id.*

60. *Id.* at 330-31.

61. Priv. Ltr. Rul. 84-50-018 (Sept. 7, 1984); Priv. Ltr. Rul. 84-29-057 (Apr. 18, 1984); Priv. Ltr. Rul. 84-27-071 (Apr. 13, 1984); Priv. Ltr. Rul. 84-20-074 (Feb. 15, 1984); Priv. Ltr. Rul. 84-03102 (Oct. 21, 1983).

62. Priv. Ltr. Rul. 84-27-071 (Apr. 13, 1984).

63. See, Willis, *Qtip Proposed Regulations Require Careful Drafting Approaches to Maximize Flexibility*, 13 EST. PLANNING 372, 376 (1985); Priv. Ltr. Rul. 84-03-102 (Oct. 21, 1983).

64. 26 U.S.C. § 2044 (1986).

65. 26 U.S.C. § 691(a)(1)(b) (1986).

66. 49 Fed. Reg. 21,350 (1984).

67. See 49 Fed. Reg. 21,350 (1984); Priv. Ltr. Rul. 84-27-071 (Apr. 13, 1984).

68. 49 Fed. Reg. 21,357 (1984).

gulations.<sup>69</sup> Therefore, it appears once again that they have based a decision on the belief that there will be an inclusion of the income in the spouse's estate.

After the publication of the private letter rulings and the proposed regulations, many commentators emphasized the additional benefit of the QTIP in that the accumulated but undistributed income could pass to the remainderman.<sup>70</sup> Estate planners typically recommend this method of income distribution because it removes the accrued income from the probate estate and it is not included in the calculation of attorneys and executor fees.<sup>71</sup> This method of handling the undistributed income also has the practical effect of providing some distribution to the remaindermen or next beneficiaries prior to the culmination of the probate process.

Most of these commentators have not questioned the IRS' interpretation of this particular point and note it without any qualification as a possible problem.<sup>72</sup> One commentator notes in his article concerning the QTIP proposed regulations:

If the governing instrument provides that all income is payable to the donee spouse for life but that any income earned between the last income distribution date and the date of the donee spouse's death is distributable to the remaindermen of the trust, the income qualifies as a qualifying income interest for life even though the remainderman is neither the donee spouse nor the donee spouse's estate.<sup>73</sup>

On the other hand, pre-regulation commentators examined the requirement of the QTIP provision and advised against using the accumulated income provision.<sup>74</sup> In examining this issue, one such commentator points out that an important element of drafting a QTIP trust is to include language assuring that the donee spouse or the donee's estate receives the accrued but unpaid income.<sup>75</sup> In recommending this approach, the author notes:

69. See Treas. Reg. § 20.2056(b)(7) (1986); see also note 63 and accompanying text.

70. Bettigole, *Post-mortem Remedies Can Salvage the Problems of Underfunded and Overfunded Marital Bequests*, 12 EST. PLANNING 66, 68 (1985); Kurtz, *The Proposed QTIP Regulations and Their Siblings*, 20 U. MIAMI L. CENTER INST. ON EST. PLAN. 1100 (1986); see also EST. PLANNING REV., April 1984 (CCH) (under heading "Brief Idea"); 22A Fed. Tax Coordinator 2d (Res. Inst. Am.) § R6393.

71. See Kurtz, *supra* note 70, at 1104.

72. *Id.*

73. *Id.*

74. Moore, *The New Marital Deduction, Qualified Terminable Interest Trust: Planning and Practice Considerations*, 16 U. MIAMI L. CENTER INST. ON EST. PLAN. 900, 902 (1982); Sherman, *How to Draft QTIP Provisions for Maximum Flexibility, Effectiveness*, 11 EST. PLANNING 158, 159 (1984) (suggesting the inclusion of provision that "upon the death of my wife, any income received or accrued by the trust prior to the time of death and not paid to her shall then pass to her personal representative as a part of her general probate estate").

75. Moore, *supra* note 74, at 901.

In a life estate—power of appointment trust, usually the spouse is given a general power of appointment over such income, and the problem is solved. However, it is not clear whether for purposes of qualification as a QTIP trust, a general power of appointment given the spouse over the accrued, but unpaid trust income, will suffice (although it arguably should).<sup>76</sup>

The accumulated income provision, which *Howard* addressed, is relatively minor as far as its use as an estate planning technique. As noted before, it is primarily used to reduce the cost of administering the estate.<sup>77</sup> However, the language in question is recommended by estate planners,<sup>78</sup> and is often found in the “boilerplate” of wills and trusts.<sup>79</sup> In some states, this disposition of the trust is made by operation of law.<sup>80</sup> The importance of the language escalates because the benefits of the entire QTIP and marital deduction could be lost if the unaccumulated income provision is included, or if it is applicable and the *Howard* decision stands.

The duty to enforce and administer the Internal Revenue Code is delegated by Congress to the IRS and not the courts.<sup>81</sup> The courts typically defer to the treasury regulations developed by the IRS when these regulations interpret the mandate of Congress in a reasonable manner.<sup>82</sup> In judicial review of a final treasury regulation, the court must sustain the regulation unless it is unreasonable or plainly inconsistent with the governing statute.<sup>83</sup> In considering whether a regulation is reasonable, consideration is given first to whether the IRS interpretation “harmonizes with the statutory language.”<sup>84</sup> The court then considers the legislative history and purpose behind the enactment of the statute.<sup>85</sup>

In *Howard*, the regulation that addresses this issue is a proposed regulation and the IRS does not directly rely on it in arguing its case.<sup>86</sup> Proposed regulations are not given the judicial deference that a final regulation mandates.<sup>87</sup> Even if the regulation was final, it would not add any weight to the IRS position because a similar result would be reached by applying the “consistent and reasonable” test to the holding in *Howard*.

The statutory language reads that “the surviving spouse is entitled to all the income from the property, payable annually or at more frequent

76. *Id.*

77. See Kurtz, *supra* note 70, at 1104.

78. See Bettigole, *supra* note 70; Kurtz, *supra* note 70.

79. Moore, *supra* note 74, at 902.

80. *Id.*

81. *United States v. Cartwright*, 411 U.S. 546, 550 (1973).

82. *United States v. Correll*, 389 U.S. 299, 307 (1967).

83. *Commissioner v. South Tex. Lumber Co.*, 333 U.S. 496, 501, *reh'g denied*, 334 U.S. 813 (1948).

84. *Bolton v. Commissioner*, 694 F.2d 556, 560-61 (9th Cir. 1982).

85. *Id.*

86. *Howard*, 91 T.C. at 337.

87. *Laglia v. Commissioner*, 88 T.C. 894, 897 (1987).

intervals . . . .”<sup>88</sup> In interpreting statutes, including the Internal Revenue Code, the words of the statute are to be interpreted in their ordinary, everyday sense.<sup>89</sup> When the language here is given an ordinary and everyday interpretation, it strongly suggests that “all the income for life” is not limited to that income actually received during life, as the IRS argues.<sup>90</sup> Rather, the language of the statute only suggests that it be paid no less frequently than annually.<sup>91</sup> Section 2056(b)(5) has language identical to the regulation.<sup>92</sup> Since related sections using the same terms should be read to achieve consistency and harmonious construction, section 2056(b)(5) also supports this position.<sup>93</sup>

Section 2056(b)(5) is the terminable interest exception for a power appointment trust under the marital deduction.<sup>94</sup> Under section 2056(b)(5), a marital deduction is allowed if:

- (1) a property interest passes from the decedent to the surviving spouse;
- (2) the surviving spouse is entitled for life to all the income from the estate;
- (3) the income is payable annually or at more frequent intervals;
- (4) there is power in the surviving spouse to appoint the entire interest;
- (5) there is no power in any other person to appoint any part of the interest.<sup>95</sup>

The QTIP statute is nearly identical to section 2056(b)(5). It only removes requirement (4) above concerning the power of appointment.<sup>96</sup> Most importantly, the statute’s language with respect to the income in section 2056(b)(5) is identical to that in the QTIP exception.

The IRS’s argument that the language “payable annually” is not a separate requirement, but a limitation on the word “all”, fails when it is examined against Treasury Regulation section 20.2056(b)-5(a). The regulations state that a power of appointment interest is deductible if it satisfies five requirements. Two of these requirements include the following:

- (1) The surviving spouse must be entitled for life to either all of the income from the entire estate or a specific portion of such. Alternatively, she may also be entitled to a specific portion of all the income from the entire interest.

88. 26 U.S.C. § 2056(b)(7)(B)(ii)(I) (1986).

89. *Quinlan v. Commissioner*, 599 F.2d 269, 271-72 (8th Cir.), *cert. denied*, 444 U.S. 996 (1979); *William Powell Co. v. United States*, 524 F. Supp. 841, 845 (S.D. Ohio 1981).

90. *Howard*, 91 T.C. at 334.

91. *Id.* at 335.

92. 26 U.S.C. § 2056(b)(5) (1986). The “surviving spouse is entitled for life to all the income from the entire interest, . . . payable annually or at more frequent intervals.” *Id.*

93. *In re Samoset Assocs.*, 14 Bankr. 408, 411 (D. Me. 1981).

94. Treas. Reg. § 20.2056(b)-5(f) (1986).

95. 26 U.S.C. § 2056(b)(5) (1986).

96. *See* 26 U.S.C. § 2056(b)(7) (1986).

(2) The income payable to the surviving spouse must be payable annually or at more frequent intervals.<sup>97</sup>

In addition to contradicting the IRS's argument concerning the single requirement, Regulation section 20.2056 shows that "all income" is not limited in any way, and that the proposed regulation in question is completely inconsistent with a similar provision in the same section. Further, Treasury Regulation sections 20.2056(b)-5(f) provide, directly on point, that "the conditions in paragraphs (a)(1) & (2) are satisfied if . . . as respects the income for the period between the last distribution date and the date of the spouse's death, it is sufficient if that income is subject to the spouse's power to appoint."<sup>98</sup>

As noted by *Howard*,<sup>99</sup> the legislative history of the QTIP provisions is not extensive. The available history, however, gives further support for the position taken by the tax court: that the IRS interpretation is inconsistent and unreasonable under the circumstances.<sup>100</sup>

In enacting the QTIP exception to the terminable interest rule, Congress intended three requirements for a qualifying income interest:<sup>101</sup> 1) "the spouse must be entitled for a period measured solely by the spouse's 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,"<sup>102</sup> 2) income interests that terminate upon the occurrence of a stated event will not qualify for the QTIP election,<sup>103</sup> and 3) the spouse must be provided with "rights to the income which are sufficient to satisfy the rules applicable to marital deduction trusts under present law (Treas. Reg. § 20.2056(b)-(f))."<sup>104</sup>

The IRS interpretation does not appear to meet any of the criteria set forth by Congress in the legislation.<sup>105</sup> The first requirement set out above supports the reading of the statute in its plain meaning. Reading the statute and the legislative history together, it is clear that the phrase "all income for life" means all income earned during the time measured by the life of the surviving spouse unqualified by when it was paid. Secondly, the surviving spouse's interest must not terminate upon any occurrence.<sup>106</sup> In *Howard*, the surviving spouse's interest in the accrued but unpaid or

97. Treas. Reg. § 20.2056(b)-5(a)(1)-(2) (1986).

98. Treas. Reg. § 20.2056(b)-5(f) (1986).

99. *Howard*, 91 T.C. at 334.

100. *Id.* at 336-37.

101. H.R. REP. No. 201, 97th Cong., 1st Sess., at 161 (1981).

102. *Id.*

103. *Id.*

104. *Id.*

105. *Id.*

106. *Id.*

undistributed income was terminated by her death, thus failing to fulfill the requirement of the statute.<sup>107</sup>

The final requirement set out by Congress requires that a qualifying income interest for life "must provide the spouse with rights to income which are sufficient to satisfy the rules applicable to marital deduction trusts under present law (Treas. Reg. § 20.2056(b)-(f))."<sup>108</sup> The third requirement for a qualifying income interest reinforces the argument that the QTIP provision should be read to include rights in the income belonging to a surviving spouse under section 2056(b). This is based on the language of section 2056(b), which states specifically that the accumulated but unpaid income of the trust from the date of the last distribution to the surviving spouse's death must be under the power of the surviving spouse.<sup>109</sup>

The IRS' interpretation of the QTIP statute directly contradicts, in this one key respect, the regulations for section 2056(b)(5). In addition, the IRS does not offer any support for its position. Furthermore, its interpretation is inconsistent with the intent of Congress and the wording of the statute. This is made clear by the plain meaning of the language used in the statute. This conclusion is also supported by the fact that two sections of the same code use identical language, and that Congress specifically stated that the two should be applied in the same manner. The inconsistency resulting from the IRS interpretation reaches the level of unreasonableness and requires a reversal of its position.

The IRS does not concede the ruling handed down in *Estate of Howard*. It had intended to take one or more of the following actions: 1) appeal, 2) finalize the proposed regulations, or 3) seek clarifying legislation.<sup>110</sup> However, it is unlikely that the outcome will differ from the result in *Estate of Howard*.

Most jurisdictions have found that

where property is given in trust to pay the income to a beneficiary for life and on his death to pay principal to others, such income as has been received by the trustee or has accrued prior to the death of the life beneficiary and has not been paid to him is payable to his personal representatives, unless it is otherwise provided by the terms of the trust.<sup>111</sup>

107. See *Howard*, 91 T.C. at 330-31.

108. H.R. REP. NO. 201, 97th Cong., 2d Sess., at 161 (1981).

109. See Treas. Reg. § 20.2056(b)-5(f)(8) (1986).

110. I.R.S. Notice 89-4, 1989-2 I.R.B. 14.

111. W.F. FRATCHER, *SCOTT ON TRUSTS* § 235A (4th ed. 1987); *First Nat'l Bank v. McGuire*, 184 F.2d 620 (7th Cir. 1950); see also CAL. PROB. CODE § 21524 which provides:

[I]n case of qualified terminable interest property, . . . on termination of the interest of the transferors spouse in the trust all of the remaining accrued or undistributed income shall pass to the estate of the transfers spouse, unless the instrument provides a different disposition that qualifies for the marital deduction.

*Id.*

Therefore, the language of a will or trust which states that the "trust income is to be paid for life," in most states, will obtain the result required by the decision in *Estate of Howard* and be eligible for the QTIP provision.

#### CONCLUSION

Estate planners should be wary of following the IRS' proposed regulations and should check their particular state's interpretation of "income for life." It probably is best, even where unnecessary, to direct that "all income," including income accumulated but undistributed prior to death, pass to the spouse's estate by a general power of appointment over the income in question.<sup>112</sup>

For those estates presently open, the IRS has established a settlement arrangement<sup>113</sup> which must be entered into prior to closing to avoid retroactive application of the *Estate of Howard* decision should the IRS ultimately lose or change positions.<sup>114</sup>

THOMAS F. O'CONNOR

112. Note that in Missouri the legislature has attempted to correct by statute those estate planning documents which are already in existence that had relied on the IRS's position so as to avoid the loss of the QTIP election and marital deduction. H.R. 145, 85th Gen. Ass., May 12, 1989 (to be codified at Mo. REV. STAT. § 456.750(6) (1989)).

113. The IRS has initiated the following procedures for estates which have the same language as *Estate of Howard* and otherwise meet the requirements of the QTIP exception:

[P]ersons having an interest in the trust will formally acknowledge that the marital deduction is allowable for the property passing to the trust and that the spouse's interest in the trust is a "qualifying income interest for life" for purposes of sections 2044 and 2519. . . . The terms of the settlement will be embodied in a closing agreement under section 7121 signed by the Service's authorized representative and all persons having an interest in the trust. . . . The settlement procedure is available with respect to any transfer in trust for which the applicable period of limitations remains open, including a transfer reported on a return that is subject of a closing letter issued by the District Director. It will remain available with respect to any such transfer until the later of December 31, 1989, or the date that is ninety days after the date the District Director gives the taxpayer written notice of the availability of the procedure.

IRS Notice 89-4, 1989-2 I.R.B. 15.

114. *Id.*