



OFFICE OF
CHIEF COUNSEL

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

MEMORANDUM FOR ASSISTANT DISTRICT COUNSEL

FROM: ASSISTANT CHIEF COUNSEL

SUBJECT:

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

ISSUE:

Has there been a disposition of the surviving spouse's income interest in her QTIP trust for purposes of section 2519?

CONCLUSION:

Upon the facts received, we conclude that this case should be conceded. Petitioner continues to receive income from the trust via the limited partnership interests and thus this case is not the appropriate vehicle to assert the disposition argument.

FACTS:

Petitioner is the beneficiary of a QTIP trust established pursuant to the terms of a trust agreement dated Date 1 by her deceased spouse. Petitioner and her only daughter are co-trustees. In Date 2, the assets of the trust consisted entirely of M. On Date 3, Petitioner gifted \$X1 to her daughter.

On, Date 4 petitioner, her daughter, her daughter's two children and the QTIP trust formed a family limited partnership ("FLP"). Daughter contributed \$X2 for #X1 general partnership units and \$X3 in assets for #X2 limited partnership units. Each grandchild contributed \$X4 for #X3 general partnership interests. Petitioner contributed cash and securities totaling \$X5 in exchange for #X4 limited partnership units. The QTIP trust contributed cash and securities totaling \$X6 for #X5 limited partnership units.

The partnership agreement provides that the managing partner, (daughter), has sole discretion with respect to distribution decisions. The limited partners are prohibited from participating in the operation or management of the business of the partnership. Partnership interests may be transferred to parents and lineal descendants. With respect to other transfers, the other partners have the exclusive right to purchase the interest for 70% of its fair market value. Petitioner has continued to receive income distributions in approximately the same amounts that she would have received had the partnership not been created.

The Commissioner issued a statutory notice of deficiency on Date 5 which determined that petitioner was liable for a gift in the amount of \$X7 on the transfer of the assets from the trust to the FLP. The statutory notice did not state or imply any legal authority for its determination. The RAR suggested that the family limited

partnership interests received in exchange for the assets had little or no value, and thus a rudimentary “gift on formation” argument for the FLP applied.

In light of the limited factual development and the high hazards of litigation, appeals was willing to concede this case until it realized that the trust was a QTIP trust. At that point, appeals began to consider whether Internal Revenue Code section 2519 applied. A Field Service Advice was subsequently requested on this issue.

LAW AND ANALYSIS

Under section 2056(a) a marital deduction is allowed for interests in property that pass from a decedent to a surviving spouse. This rule, however, is not without exceptions. Section 2056(b)(1) disallows the deduction for interests which will not remain in the spouse’s estate, such as a life estate in property with a remainder to the decedent’s children. Because spouse’s interest would terminate upon death, there would be nothing left in the gross estate to tax. Hence this type of interest is coined a “terminable interest.”

Nonetheless, section 2056(b)(7) allows the deduction for certain special types of terminable interests. Specifically, a deduction is allowed for “qualified terminable interest property” placed in a trust (“QTIP trust”). Under 2056(b)(7) the entire value of both the life estate and the remainder qualify for the marital deduction. A QTIP trust gives the spouse the right to income for life and a limited right to invade the principal, but no right to appoint the remainder.

In order to qualify as QTIP property, three requirements must be met: 1) the property must pass from decedent, 2) the surviving spouse must have a qualifying income interest for life in the property, and 3) decedent’s executor must elect to apply section (2056)(b)(7). A qualifying income interest for life is the right to all the income from the property for the spouse’s life payable annually or more frequently and no one may have a power to appoint any part of the property to any person other than the surviving spouse. Section (2056)(b)(7)(B)(ii)(I) and (II).

If the surviving spouse disposes of all or any part of the qualifying income interest section 2519 treats the spouse as having gifted the remainder. Yet, there are several actions a surviving spouse can take in regard to the trust without effecting a disposition of the qualifying income interest. The surviving spouse has the right to force the trustee to make the property productive by, for instance, converting it to income producing assets, so long as the surviving spouse continues to have a qualifying income interest for life in the trust after the sale and reinvestment. Treas. Reg. 20.2056(b)-5(f) and 20.2519-1(f).

As applied to the facts of our case, petitioner's conversion of the trust assets into FLP interests is not the typical disposal of the income interest envisioned under the provisions of section 2519. By converting the trust assets into FLP interests, she has disposed of the corpus rather than the qualifying income interest. Facially this appears to be a permissible conversion. Thus, in order to invoke 2519, the conversion of the trust assets must work such a limitation on her right to the income as to amount to a disposition of that income. Although the conversion to partnership interests could yield this result, it does not necessarily follow. An investment in a partnership, despite possible restrictions on distribution, could be, under the right circumstances, a very lucrative investment.

Moreover, although the managing partner of the FLP had the right to accrue and not distribute the partnership income, the facts show that such has not been the case. Petitioner has continued to receive her income unabated since the formation of the FLP. No action of Petitioner's has affected her right to income from the trust; that right still exists. The fact that she might not, in a hypothetical world, actually receive income does not destroy her right to any income, if such income exists. Moreover, QTIPs can be originally funded with partnership interests or, for that matter, closely held stock. Both of these investments could distribute no income in any given year. The right to annual income is not tantamount to a fixed right to yearly income, rather it is a right to any income to the extent it exists, on at least an annual basis.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

[REDACTED]

Accordingly, these factors render this case unfit to test the 2519 disposition issue and we recommend concession.

ASSISTANT CHIEF COUNSEL
CC:DOM:FS

By: _____

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