UNITED STATES TAX COURT

WASHINGTON, DC 20217

ESTATE OF VIRGINIA V. KITE, DONOR, DECEASED, BANK OF OKLAHOMA, N.A., EXECUTOR/TRUSTEE,	)	Rm
Petitioner	)	Docket No. 6772-08.
v.	)	
COMMISSIONER OF INTERNAL REVENUE,	)	
Respondent	)	

ORDER AND DECISION

The Court issued a Memorandum Findings of Fact and Opinion (T.C. Memo. 2013-43) on February 7, 2013. The Court held that the portions of the annuity value originally traceable to decedent's qualifying terminable interest property (QTIP) trusts, less the value of the qualifying income interests, were subject to Federal gift tax. As a result, the Court required the parties to provide computations for entry of decision under Rule 155[1] in accordance with the Court's Memorandum Findings of Fact and Opinion.[2]

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[1]Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended, and all Rule references are to the Tax Court Rules of Practice and Procedure.

[2]On Sept. 10, 2009, Estate of Virginia V. Kite, Deceased, Bank of Oklahoma, N.A., Executor/Trustee, docket No. 6773-08, was consolidated with this case (docket No. 6772-08) for trial, briefing, and opinion. Docket No. 6773-08 addressed petitioner's estate tax liability. The parties have each filed a computation for entry of decision in regard to petitioner's estate tax liability for calendar year 2004. A separate Decision will be entered in regard to the estate tax under Rule 155.

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On May 7, 2013, respondent filed his Computation for Entry of Decision claiming that petitioner's gift tax deficiency for tax year 2001 is $816,206. On May 9, 2013, petitioner filed its Computation for Entry of Decision claiming that there is no gift tax due for 2001.

On June 19, 2013, petitioner filed its objection to respondent's computations. On June 21, 2013, respondent filed his objection to petitioner's computations, as well as a brief in support of his computations. On July 16, 2013, petitioner filed its response to respondent's brief in support of respondent's computations and its response to respondent's objection to petitioner's computations. On July 30, 2013, respondent filed his reply to petitioner's response to respondent's brief in support of respondent's computations and his reply to petitioner's response to respondent's objection to petitioner's computations.

Background

Virginia V. Kite, decedent, was the sole lifetime income beneficiary of two QTIP trusts upon the death of her husband, James B. Kite, and their three children (Kite children) were the remainder beneficiaries. In 2001, the year at issue, the sole asset of the QTIP trusts was a 24.87% ownership interest in Kite Family Investment Co. (KIC), a family general partnership.

On March 28, 2001, Mrs. Kite appointed the Kite children as the trustees of her QTIP trusts. The Kite children contemporaneously terminated the QTIP trusts, and as a result the QTIP trust assets were transferred to Mrs. Kite's lifetime revocable trust. Two days later, on March 30, 2001, Mrs. Kite's lifetime revocable trust sold its entire interest in KIC to the Kite children or their trusts for three unsecured annuity agreements.

As more fully explained in the Memorandum Findings of Fact and Opinion, the Court viewed the termination of the QTIP trusts and the immediate sale of their assets through Mrs. Kite's lifetime revocable trust as a single transaction that triggered the transfer tax consequences of section 2519. Consequently, the Court found that Mrs. Kite made a disposition of her qualifying income interest for

purposes of section 2519; and as a result, the proportionate share of the annuity value that was originally traceable to the QTIP trusts, less the qualifying income interests therein, was subject to Federal gift tax.

The proportionate share of the annuity value that was traceable to the QTIP trusts was not readily apparent. The Court therefore required the parties to submit computations for entry of decision under Rule 155 in accordance with the Memorandum Findings of Fact and Opinion.

Section 2519 Gift Tax Calculation

According to their computations, the parties agree that the fair market value of the QTIP trust assets was $2,665,106 and on the disposition date the value of the remainder interest was $1,484,011.[3] The computations for entry of decision, however, differ because the parties disagree on the operation of section 2519.

Section 2519(a) provides that any disposition of all or part of a qualifying income interest for life in any property to which the section applies is treated as a transfer of all interests in the property other than the qualifying income interest.

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[3]This value is derived from the stipulation of the parties that Mrs. Kite's 99% interest in KIC, which on the date of the annuity transaction was held entirely by her revocable trust, was worth $10,605,278. The QTIP trusts collectively held a 24.87% ownership interest in KIC before the annuity transaction, which is 25.13% (or 24.87% divided by 99%) of the revocable trust's interest in KIC. Therefore, the total value of the KIC ownership interests traceable to the QTIP trusts was equal to 25.13% of $10,605,278, or $2,665,106. To that value the parties applied a remainder factor of 0.55683 for a remainder interest of $1,484,011. The remainder factor was determined under sec. 20.2031-7(d)(7), table S, Estate Tax Regs., effective May 1, 1999, see 64 Fed. Reg. 23187 (Apr. 30, 1999), 1999-1 C.B. 1000; with the sec. 7520 interest rate of 6.2% applicable in March 2001, see Rev. Rul. 2001-12, 2001-1 C.B. 811. The value of the income interest was $1,181,095, which is $2,665,106, less the remainder interest of $1,484,011.

Section 25.2519-1(a), Gift Tax Regs., provides further guidance for the operation of section 2519 as follows: "[T]he donee spouse is treated as making a gift under section 2519 of the entire trust less the qualifying income interest * * * A transfer of all or a portion of the income interest of the spouse is a transfer by the spouse under section 2511." Thus, upon the disposition of all or part of a qualifying income interest, the donee spouse is treated as making a gift of the remainder interest. The transfer consequences of the income interest is determined separately under section 2511.

The amount treated as a transfer under section 2519 is described in section 25.2519-1(c), Gift Tax Regs., as "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."

In the Memorandum Findings of Fact and Opinion, the Court held that Mrs. Kite made a disposition of her qualifying income interest for purposes of section 2519 when her QTIP trusts terminated and their assets were transferred, via Mrs. Kite's revocable trust, to her children or their trusts for the annuity agreements in tax year 2001. The parties agree that the fair market value of the QTIP trust assets was $2,665,106 and on the disposition date the value of the annuity that was traceable to remainder interest in the QTIP trusts was $1,484,011. Accordingly, for purposes of section 2519, Mrs. Kite is treated as making a gift of $1,484,011 for tax year 2001, see sec. 25.2519-1(a), Gift Tax Regs., and has a gift tax liability of $816,206.

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Petitioner's Objections[4]

In petitioner's computations filed on May 9, 2013, petitioner claims that there is no gift tax due for tax year 2001. To support its computations, petitioner relies primarily on the Court's finding that the annuity transaction was a bona fide sale for adequate and full consideration.

After the QTIP trusts were terminated and their assets were distributed to Mrs. Kite's revocable trust, Mrs. Kite sold her revocable trust's interest in KIC to her children for the annuity agreements. For the reasons provided in the opinion, the Court found that the annuity transaction was a bona fide sale for adequate and full consideration. Petitioner understands this finding to mean that upon the section 2519 disposition event "Mrs. Kite is deemed to have transferred an income interest in the KIC interests worth $1,181,095 in exchange for consideration worth $1,181,095" and "a remainder interest in the KIC interests worth $1,484,011 in exchange for consideration worth $1,484,011". Therefore, according to petitioner, Mrs. Kite received "full and adequate consideration" for both the qualifying income interest and remainder interest in the QTIP trusts at issue.

Petitioner argues that because Mrs. Kite received "full and adequate consideration" for the remainder interest in the QTIP trusts, Mrs. Kite's gift tax liability under section 2519 is zero. Petitioner relies on the following "principle" in Commissioner v. Wemyss, 324 U.S. 303, 307 (1945) (citation omitted), that a "transfer becomes subject to the gift tax to the extent that it is not made 'for an adequate and full consideration in money or money's worth.'" Petitioner also relies on sec. 25.2511-1(g), Gift Tax Regs., which provides that "[t]he gift tax is not applicable to a transfer for a full and adequate consideration in money or money's worth".

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[4]Respondent argues that petitioner's objections are all new issues and are therefore waived. Notwithstanding respondent's position, the Court will address petitioner's objections without making a determination as to whether petitioner raised new issues in order to resolve any misunderstanding of the Memorandum Findings of Fact and Opinion.

Petitioner is mistaken for the following reasons.

Petitioner incorrectly interprets the Court's finding to mean that Mrs. Kite received full and adequate consideration for both the qualifying income interest and the remainder interest. The annuity transaction was only one part of the section 2519 disposition event. On the facts of this case, the Court found that the simultaneous termination of the QTIP trusts and the sale of their assets through Mrs. Kite's revocable trusts triggered the transfer tax consequences of section 2519. By focusing on the annuity transaction, and specifically the Court's finding that Mrs. Kite received full and adequate consideration, petitioner ignores the significance of the QTIP trust terminations that immediately preceded the annuity transaction.

Although the Court is not bound by interpretations of the law in the Commissioner's revenue rulings, see, e.g., Johnson v. Commissioner, 115 T.C. 210, 224 (2000), Rev. Rul. 98-8, 1998-1 C.B. 541, is particularly helpful in understanding the gift tax consequences of the QTIP trust terminations for purposes of section 2519. In Rev. Rul. 98-8 the Commissioner considered the gift tax consequences to a surviving spouse upon acquiring the remainder interest in a QTIP trust. The surviving spouse, who had a qualifying income interest in the QTIP trust, proposed to purchase the remainder interest with a promissory note of face value equal to the remainder interest. After purchasing the remainder interest the trustee would distribute all of the QTIP trust assets to the surviving spouse, who would then satisfy the promissory note using the QTIP trust assets.

The Commissioner found that the transaction was a disposition by the surviving spouse of the qualifying income interest, resulting in a gift under section 2519 of the value of the remainder interest. The Commissioner, relying on the House Ways and Means Committee report explaining the expansion of the marital deduction and the QTIP provisions, see H.R. Rept. No. 97-201, at 161 (1981), 1981-2 C.B. 352, 378, determined that for purposes of section 2519 the term "disposition" applies broadly to circumstances in which the spouse's right to receive the income is relinquished or otherwise terminated by whatever means.

As described in Rev. Rul. 98-8, a commutation, which is a proportionate division of trust property between the life beneficiary and remainderman based on the respective values of their interests, is one example of a section 2519 disposition event. In the context of a QTIP trust, a commutation of a spouse's qualifying income interest in the QTIP trust is essentially a sale of the qualifying income interest by the spouse to the trustee (or the remainderman) in exchange for an amount equal to the value of the qualifying income interest. See, e.g., sec. 25.2519-1(f), Gift Tax Regs. ("[T]he sale of qualified terminable interest property, 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."). Therefore, under section 2519, a commutation results in a deemed transfer of the remainder interest.[5]

Similarly, before transferring the QTIP trust assets to the Kite children, the remaindermen, the QTIP trusts were terminated and their assets were distributed to Mrs. Kite's revocable trust. Under the reasoning provided in Rev. Rul. 98-8, the termination of the QTIP trusts alone triggered section 2519, resulting in the disposition of Mrs. Kite's qualifying income interest in the QTIP trusts in exchange for an amount equal to the value of the qualifying income interest.

The Court, however, did not need to determine whether the termination of the QTIP trusts alone triggered the gift tax consequences of section 2519. Instead, the Court found that the termination of the QTIP trusts and the annuity transaction were a single transaction and combined resulted in a disposition of Mrs. Kite's qualifying income interest in the QTIP trusts. Nonetheless, petitioner's focus on

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[5]Notably, this result is exemplified in the General Explanation of the Economic Recovery Tax Act of 1981 by the Staff of the Joint Committee on Taxation as follows: "For example, if a court ordered the termination of a trust containing QTIP prior to the donee spouse's death and distributed the trust assets to the donee spouse and the remaindermen, the donee spouse would be treated as making a gift of the entire value of the remainder interest under section 2519." Staff of J. Comm. on Taxation, General Explanation of the Economic Recovery Tax Act of 1981, at 235 (J. Comm. Print 1981).

the annuity transaction without taking into account the termination of the QTIP trusts is misguided because the termination of a QTIP trust can result in a transfer of a qualifying income interest for purposes of section 2519. As respondent correctly points out, the annuity transaction was an intermediary step between terminating the QTIP trusts and selling the QTIP trust assets to the Kite children designed to circumvent the QTIP regime and avoid any deemed transfer under section 2519.

Accordingly, the Court's finding that Mrs. Kite received full and adequate consideration in the annuity transaction does not mean, as petitioner proposes, that she received full and adequate consideration for the qualifying income interest and remainder interest.

The Court's finding does not suggest that adequate consideration is equivalent to a qualifying income interest which would have preserved the deferral of the tax obligation created upon Mr. Kite's death. See sec. 25.2519-1(f), Gift Tax Regs. Adequate consideration is not equal to a qualified income interest whether or not the qualified income interest is placed in or out of trust. See sec. 25.2519-1(f), Gift Tax Regs. ("[T]he sale of qualified terminable interest property, 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."); see also Staff of J. Comm. on Taxation, General Explanation of the Economic Recovery Tax Act of 1981, at 235 (J. Comm. Print 1981) ("The [Economic Recovery Tax Act of 1981] does not limit qualifying income interests to those placed in trust. However, the Congress intended that the rules applicable to interests not in trust be similar to the rules applicable to qualifying income interests which are in trust."). In fact, a deemed transfer of a remainder interest under section 2519 cannot be made for adequate and full consideration or for any consideration.

As discussed above, section 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. As explained in the Court's Memorandum Findings of Fact and Opinion, the policy behind the marital deduction is that property passes untaxed from a predeceasing spouse to a surviving spouse but is then included in the estate of the surviving spouse. Estate of Letts v. Commissioner, 109 T.C. 290, 295 (1997), aff'd without published opinion, 212 F.3d 600 (11th Cir. 2000). The marital deduction does not eliminate the estate tax on marital assets but merely permits a deferral of tax until the death of the surviving spouse.

Before 1981 terminable interest property did not qualify for marital deductions. In 1981 Congress expanded the marital deduction and created the concept of "qualified terminable interest property", which allowed the executor to make an irrevocable election to treat certain property as a qualifying income interest for the life of the spouse. The QTIP provisions would allow QTIP to pass to a surviving spouse tax free provided that the QTIP is subject to transfer taxes at the earlier of (1) the date on which the surviving spouse disposes (either by gift, sale, or otherwise) of all or part of the qualifying income interest, or (2) upon the surviving spouse's death. See H.R. Rept. No. 97-201, supra at 161, 1981-2 C.B. at 378. Therefore, the "taxable event" for QTIP occurred when the predeceasing spouse died, but the tax is merely deferred until the surviving spouse disposes of all or part of the qualifying income interest, or upon the surviving spouse's death. Eliminating the gift tax on the remainder interest would circumvent the QTIP regime and the tax it intended to preserve.

In Mr. Kite's Last Will and Testament, Mrs. Kite was appointed copersonal representative of Mr. Kite's estate. Although Mrs. Kite did not sign Mr. Kite's estate tax return, as a copersonal representative of his estate she was aware of the section 2056(b)(7) election made on the estate return for the QTIP trusts, thereby qualifying the trust property passing to Mrs. Kite for the marital deduction. Thus, she was not only obligated to pay the transfer tax due on the terminable interest property she received upon the earlier of her disposition of all or part of her

qualifying income interest or her death, but she also participated in the decision to defer this tax. Accordingly, Mrs. Kite was on notice that this tax would be eventually due and owing and her responsibility for the tax did not disappear upon the termination of her QTIP trusts.

Finally, petitioner argues that Congress intended to reduce the amount taxable under section 2519, i.e., the remainder interest, by the amount the surviving spouse receives upon disposing of the income interest. Petitioner cites the House of Representatives Committee on Ways and Means report for the expansion of the marital deduction, which provides that: "If the property is subject to tax as a result of the spouse's lifetime transfer of the qualifying income interest, the entire value of the property, less amounts received by the spouse upon disposition, will be treated as a taxable gift by the spouse under new Code sec. 2519." See H.R. Rept. No. 97-201, supra at 161, 1981-2 C.B. at 378. Under this theory, petitioner claims that the QTIP trust assets had a value of $2,665,106, which equals the amount Mrs. Kite received in the annuity transaction. Therefore, according to petitioner, the amount taxable under section 2519 is zero.

When read in isolation this statement from the House report seems to support petitioner's position; however, the statement must be read in the context of the entire report.

Before the statement cited by petitioner is the following: "[P]roperty subject to an election to be treated as a qualified terminable interest will be subject to transfer taxes at the earlier of (1) the date on which the surviving spouse disposes (either by gift, sale, or otherwise) of all or part of the qualifying income interest, or (2) upon the surviving spouse's death." See id. As discussed above, this statement stems from the policy behind the marital deduction to preserve the transfer tax on QTIP until a section 2519 disposition event or the surviving spouse's death.

Immediately following the statement cited by petitioner is the following: "In general, no annual gift tax exclusion will be permitted with respect to the imputed transfer of the remainder interest (to a person other than the income beneficiary) because the remainder is a future interest. However, if the spouse

makes a gift of the qualifying income interest, the gift of the income interest will be considered a gift to the donee, eligible for the annual exclusion and marital deduction, if applicable." See id. This, too, supports the Court's finding that the remainder interest is a future interest held by the remainderman and not the surviving spouse, and therefore cannot be transferred by the surviving spouse for consideration. In fact, unlike a surviving spouse's qualifying income interest, which is treated separately for tax purposes under section 2511, the deemed transfer of a remainder interest under section 2519 is a gift.

Accordingly, the amount treated as a transfer of the remainder interest under section 2519 is properly described in section 25.2519-1(c), Gift Tax Regs., as "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." Therefore, for purposes of section 2519, Mrs. Kite is treated as making a gift of the remainder interest in her QTIP trusts equal to $1,484,011 for 2001.

Respondent argues that petitioner failed to raise these new issues on brief and therefore these arguments have been waived. Respondent also argues that petitioner is precluded from raising new issues that are outside the scope of Rule 155(c).

Generally, new issues may not be raised in a Rule 155 proceeding. Rule 155(c); Harris v. Commissioner, 99 T.C. 121, 123 (1992), aff'd, 16 F.3d 75 (5th Cir. 1994). Rather, issues raised in a Rule 155 proceeding are limited to "purely mathematically generated computational items". Id. (quoting The Home Group, Inc. v. Commissioner, 91 T.C. 265, 269 (1988), aff'd, 875 F.2d 377 (2d Cir. 1989)). The Court has considered the parties' arguments and, to the extent the parties raised new issues, the Court finds that they are precluded by Rule 155(c).

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In view of the foregoing, and pursuant to the determination of this Court as set forth in its Memorandum Findings of Fact and Opinion (T.C. Memo. 2013-43), filed February 7, 2013, it is

ORDERED and DECIDED that there is a deficiency in Federal gift tax due from petitioner in the amount of $816,206 for the calendar year 2001.

(Signed) Elizabeth Crewson Paris
Judge

ENTERED: OCT 2 5 2013