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The World's Greatest Gift Tax Mystery, Solved

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Introduction

As a general rule, when a spouse is given a terminable interest, the marital deduction is not available. There are, however, two important exceptions: when the trust qualifies for the qualified terminable interest property (QTIP) election (and the election is made) and when the spouse is given an income interest coupled with a general power of appointment. The terminable interest rule in the gift tax context, found in section 2523(b), has two components: one in section 2523(b)(1) and the other in section 2523(b)(2). If a donor spouse makes a lifetime gift to his spouse and the QTIP or general-power exception applies, the aspect of deduction may still be denied if the requirements of section 2523(b)(2) are not satisfied. In other words, even if the QTIP or general-power exception applies, the deduction is denied if the donor spouse retains a power of appointment in violation of section 2523(b)(2). Some have suggested that, as a result, the marital deduction could be denied for a lifetime QTIP when the donor spouse retains the power to appoint the trust property after the death of the donee spouse. In this article, we demonstrate that this suggestion is inconsistent with the 1981 legislative history underlying the QTIP provision. We also examine the history of section 2523(b)(2) and conclude that it was not intended to apply to a power of appointment created by the donor spouse, but rather to deal with the more limited situation in which the power has been conferred on the donor spouse by a third party.

Background

As is widely known, the Revenue Act of 1948 introduced the estate and gift tax marital deduction to even the playing field between married couples who live in community property states and those who live in noncommunity-property states. (In addition to adopting the marital deduction, the act also introduced the concept of joint income tax returns for spouses and "gift splitting," by which the nondonor spouse may elect to treat gifts by the donor spouse to persons other than the gift splitting spouse as if made one-half by the nondonor spouse.) Under community property law, as a general rule, each spouse owns an undivided one-half interest in each community asset in a manner somewhat similar, but not identical, to a tenancy in common. But as adopted by the act, the marital deduction did not cause the same estate and gift taxation for married couples in community-property and noncommunity-property states.

For example, under the act, a married person could not gift half of his interest in an asset gift tax free to his spouse. Rather, the act allowed the married person to deduct half of the value of an asset given to his spouse. In other words, if a husband in a non-community-property state gave his wife half of his interest in an asset worth $100,000 (putting aside any issue of a discount in value for a gift of a fractional interest worth $50,000), a marital deduction of only $25,000 would be allowed and $25,000 would be subject to gift tax (barring use of the annual exclusion or lifetime exemption). But, of course, if the couple lived in a community property state, both spouses would own half of each community property asset without either of them making a taxable gift.

However, the estate tax regime for noncommunity property better "simulated" the result for community property: The first spouse to die in a noncommunity-property state could exclude half of his estate (technically, half of his adjusted gross estate), exposing only half to estate tax. That would be closer to what would happen in a community property state: The half owned by the surviving spouse in the couple's community property would not be subject to estate tax (functioning almost like the 50 percent marital deduction), while the half owned by the first spouse to die would be subject to tax.

Beginning in 1982, the Economic Recovery Tax Act of 1981 made the marital deduction for estate and gift tax purposes unlimited. Nevertheless, a gift tax marital deduction is no longer permitted for gifts to a spouse who is not a U.S. citizen, and an estate tax marital deduction is permitted if the surviving spouse is not a U.S. citizen only when the transfer is in the form of a qualified domestic trust. See sections 2523(i) and 2056A.

Nondeductible Terminable Interests

The framers of the act also decided not to permit a deduction for specified terminable interests. The rules are currently in section 2056(b) for estate tax purposes and section 2523(b) for gift tax purposes. A terminable interest exists when, on the lapse of time, on the occurrence of an event or contingency, or on the failure of an event or contingency to occur, the interest transferred to the

spouse will terminate or fail. A life estate and an income from a trust for the life of the spouse are classic terminable interests.

A terminable interest does not qualify for estate tax purposes if an interest in the same property passes or has passed (for less than an adequate and full consideration in money or money's worth) from the decedent spouse to any person other than the surviving spouse (or the estate of that spouse) and if by reason of the passing that person may possess or enjoy any part of the property after the termination of failure of the interest so passing to the surviving spouse. Hence, if a property owner creates a 10-year income interest in his spouse with remainder over to the owner's descendants, the income interest is a nondeductible terminable interest. Note, however, that if descendants were to pay the transferor full value for the remainder interest, the marital deduction would be available for the interest given to the spouse even though it is a terminable interest.

The terminable interest rule for gift tax purposes is broader than that for estate tax purposes because, in the case of a lifetime gift, the donor spouse is still living and might retain an interest in the property to take effect after the spouse's interest ends. A terminable interest does not qualify for the gift tax marital deduction if (a) under section 2523(b)(1) the donor spouse retains in himself or transfers or has transferred (for less than an adequate and full consideration in money or money's worth) to any person other than the donee spouse (or the estate of such spouse), an interest in that property, and if by reason of that retention or transfer the donor (or his heirs or assigns) or that person (or his heirs or assigns) may possess or enjoy any part of that property after that termination or failure of the interest transferred to the donee spouse; or (b) under section 2523(b)(2) the donor immediately after the transfer to the donee spouse has a power to appoint an interest in that property that he can exercise (either alone or in conjunction with any person) in that manner that the appointee may possess or enjoy any part of that property after that termination or failure of the interest transferred to the done spouse. For section 2523(b)(2) purposes, the donor is considered as having immediately after the transfer to the donee spouse a power to appoint even though that power cannot be exercised until after the donee spouse's interest terminates.

An example falling under section 2523(b)(1) would be a property owner creating a 10-year income interest in his spouse in property with reversion back to the donor spouse; the income interest is a nondeductible terminable interest. An example falling under section 2523(b)(2) would be the donor spouse receiving an income interest and a power of appointment from a third party. If the donor spouse were to then gift the income interest to his spouse while retaining the power of appointment, section 2523(b)(2) would preclude the gift from qualifying for the marital deduction. Section 2523(b)(2) apparently applies whether the power of appointment granted to the donor spouse by the third party is a special (non-estate/non-gift taxable) or general (estate/gift taxable) power under section 2041 or section 2514.

A terminable interest will fail to qualify for the marital deduction only if one of the conditions described in section 2523(b)(1) or (b)(2) is also present. In other words, if the conditions set forth in neither section 2523(b)(1) nor section 2523(b)(2) are present, the gift tax deduction should be allowed for a gift by one spouse to the other of a terminable interest. Hence, if the donor spouse at no time held more than a terminable interest and transferred that interest in its entirety to his spouse, the marital deduction would be permitted, unless the donor spouse also held a power of appointment or holds one after the interest is transferred to his spouse. Therefore, if the donor were given by a third party a 10-year term in an asset and had no other interest or power over the property at any time, the donor could give the 10-year term to his spouse and the gift would qualify for the marital deduction.

Powers of Appointments and Terminable Interests

The flush language in section 2523(b) clarifies the scope of section 2523(b)(1). It states:

> An exercise or release at any time by the donor, either alone or in conjunction with any person, of a power to appoint an interest in property, even though not otherwise a transfer, shall, for paragraph (1) purposes, be considered a transfer by him.

That suggests that the exercise or release by the donor spouse of a power of appointment, even if not a general (taxable) power, is treated as a transfer by the donor spouse. (It seems that the phrase "not otherwise a transfer" means a nongeneral power of appointment. This construction of the phrase is supported by the legislative history to the Revenue Act of 1948. See Sen. Rep. No. 1013, pt 2, 80th Cong., 2d Sess., at 31.) Hence, if a spouse has been granted a special (nontaxable) power of appointment over property by a third party (for example, the donor's parent), and the spouse holding that power exercises it to cause the remainder to pass to his descendants on the death of his spouse and then exercises the power to grant a 10-year income interest to his spouse, the donor spouse is treated as if he had transferred the interest to the descendants. As a consequence, the transfer to the spouse of a 10-year income interest in an asset will constitute a nondeductible terminable interest under section 2523(b)(1) of the code. The rule also treats the donor spouse as having transferred an interest in the property to the appointees or those who take in default of the exercise of the power if the power has been released.

It may be of interest to note that the power of appointment rule in the flush language does not mention a lapse of a power of appointment. But sections 2041(b)(2) and 2514(e) treat a lapse of a general power of an appointment as a release, but only to the extent the lapse exceeds the greater of $5,000 or 5 percent of the value of the property subject to the power. It is not clear to what extent a lapse of a power of appointment would be treated as a release for section 2523(b)(1) purposes.

It seems that this power of appointment rule (applicable only for section 2523(b)(1) purposes) applies when the donor spouse creates both the interest in his spouse and the interest in another (or others) by the exercise or release of the power of appointment. In sharp contrast, when the donor spouse has received a term interest and a power of appointment from a third party and then gifts

the term interest to the donee spouse but retains the power, section 2523(b)(2) applies.

Under the power of appointment rule in section 2523(b)(2), if the donor spouse has a power of appointment taking effect after the expiration of the term interest, that interest does not qualify for the marital deduction even if the power is not exercisable or does not take effect until after the donee spouse dies. The section explicitly provides that "the donor shall be considered as having immediately after the transfer to the donee spouse such power to appoint even though such power cannot be exercised until after the lapse of time, upon the occurrence of an event or contingency, or on the failure of an event or contingency to occur." In other words, even if the power cannot affect the property until after the donee spouse dies, section 2523(b)(2) makes it a nondeductible interest.

Deductible Terminable Interests

As mentioned above, a terminable interest is deductible as long as it is not described, for estate tax purposes, in section 2056(b)(1), and, for gift tax purposes, in either section 2523(b)(1) or section 2523(b)(2). But the Revenue Act of 1948 allowed even some terminable interests otherwise described in the terminable interest provisions of the code to qualify for the marital deduction. The list of deductible terminable interests is somewhat different for estate and gift tax purposes. But both tax regimes permit a deduction for a life estate coupled with a general power of appointment described in sections 2056(b)(5) and 2523(e) (sometimes called a "general power of appointment marital deduction trust"). Indeed, even though others will succeed to the property after the life estate in the donee spouse ends, the marital deduction is allowed for the entire value of the property in which the spouse is given a life estate and general power of appointment (and not just the value of the life estate). In fact, section 2056(b)(5)(B) explicitly states that no part of the interest in the property is to be considered as passing to anyone other than the surviving spouse. In other words, the surviving spouse is treated as if she received the entire property (not just a life estate), and the marital deduction is permitted not just for the value of the life estate but value of the entire property.

The general power of appointment marital deduction trust rule for gift tax purposes is nearly identical, and section 2523(e)(1) explicitly states that no part of the interest in the property is to be considered as passing to anyone other than the donee spouse for section 2523(b)(1) purposes. But section 2523(b)(2) is not mentioned.

Enter Qualified Terminable Interest Property

In addition to making the marital deduction unlimited, the Economic Recover Tax Act of 1981 also revised the code to permit QTIP to qualify by election for the marital deduction. Essentially, and subject to additional conditions, QTIP is property in which the taxpayer's spouse is given a life estate. It is a life estate with general power of appointment trust described in section 2056(b)(5) or section 2523(e) but without the general power of appointment requirement. See sections 2056(b)(7) and 2523(f). Again, identical to the provisions for general power of appointment marital deduction trusts, the estate tax QTIP rules provide that no part of the interest in the property is to be considered as passing to anyone other than the surviving spouse, and the gift tax QTIP rules provide that no part of the interest in the property is to be considered as passing to anyone other than the donee spouse for section 2523(b)(1) purposes. Again, section 2523(b)(2) is not mentioned.

QTIP and Section 2523(b)(2)

The Treasury regulations issued under the gift tax general power of appointment marital deduction rules do not discuss section 2523(b)(2). The rule is briefly discussed in reg. section 25.2523(b)-1(d) but is not related to section 2523(e).

But the Treasury regulations issued under the gift tax QTIP rules provide: "Terminable interests that are described in section 2523(b)(2) cannot qualify as qualified terminable interest property. Thus, if the donor retains a power described in section 2523(b)(2) to appoint an interest in qualified terminable interest property, no deduction is allowable under section 2523(a) for the property." Reg. section 25.2523(f)-1(a)(1).

That could be read — and indeed has been read by some — as suggesting that a spouse who creates a trust during a lifetime that is otherwise described in section 2523(f) (that is, otherwise qualifying as a lifetime QTIP trust) will not be allowed a marital deduction if the donor spouse retains a power to control the disposition of the property even if that power is not exercisable until the donee spouse dies. However, at least two private letter rulings have concluded that a donor spouse may retain such a power. See LTRs 200406004, *Doc 2004-2524, 2004 TNT 26-69,* and 9437032, *94 TNT 184-53* (not precedent under section 6110(k)(3)).

Nevertheless, the language of reg. section 25.2523(f)-1(a)(1) quoted above raises the question of the scope of section 2523(b)(2). The key to understanding section 2523(b)(2) seems to be in the meaning of the term "power of appointment."

Meaning of Power of Appointment

It seems quite certain that an individual may create a power of appointment in himself or herself for local property law purposes. The Restatement of Property, section 11.1 and its comment, states,

> A power of appointment is authority, other than as an incident of the beneficial ownership of property, to designate recipients of beneficial interests in property.
>
> Comment: Inclusiveness of definition. *** The powerholder may be the creator of the power or one who is not the creator of the power (*see Comment c*).

But the understanding of a power of appointment for estate and gift tax purposes seems to be different. A power that an individual creates for himself that would be treated for property law purposes as a power of appointment is treated as a power of dominion and control for gift tax purposes and as a power to control the beneficial enjoyment of property for estate tax purposes. See reg. section 25.2511-2; sections 2036(a)(2) and 2038.

In other words, a power of appointment apparently cannot be created by the transferor of property for federal estate and gift tax purposes in himself, as a general rule. Reg. section 20.2041-1(b)(2) provides in part that "for

purposes of sections 20.2041-1 to 20.2041-3, the term 'power of appointment' does not include powers reserved by the decedent to himself within the concept of sections 2036 through 2038. (See sections 20.2036-1 to 20.2038-1.)" Similarly, reg. section 25.2514-1(b)(2) provides, in part "for purposes of sections 25.2514-1 through 25.2514-3, the term 'power of appointment' does not include powers reserved by a donor to himself."

When the Revenue Act of 1948 was drafted, the Treasury regulations contained a similar, if not clearer, rule — that a power of appointment for gift tax purposes could not encompasses a reserved power. Reg. section 86.2(b) stated, in pertinent part, "Section 1000(c) [now section 2514 of the Internal Revenue Code of 1986, as amended] does not apply to a power reserved, directly or indirectly, by a donor upon a transfer, as distinguished from the possessor of a power of appointment received from another person. See § 86.3 [which conforms to current reg. section 25.2511-2, dealing with completion of gifts by reason of retained dominion and control over the transferred property] with respect to the taxability of reserved powers."

At least one court case makes a somewhat similar statement. "Section 2041 has always been taken to be the section of subtitle B that has to do with the powers of a grantee, as opposed to a grantor, as sections 2036 and 2038 have to do with the power of a grantor." *Estate of Halpern v. Commissioner*, 70 TCM 229, *Doc 95-7511, 95 TNT 149-13* (1995). (Citation omitted.)

Also, all of the illustrations under what is now section 2523(b)(2) in the legislative history to the Revenue Act of 1948 involve solely situations in which the power of appointment was granted to the donor spouse by a third party. See Sen. Rep. No. 1013, pt. 2, 80th Cong., 2d Sess., at 30-31. Also, reg. section 25.2523(b)-1(d), in explaining the scope of section 2523(b)(2), provides as its only illustration of the section an example that seems almost certainly to involve a third-party-conferred power. Hence, it seems relatively certain that section 2523(b)(2) applies only to a power of appointment created in the donor spouse by a third party.

That seems to be reinforced by the legislative history relating to the QTIP rules. House Report 97-201, which accompanied HR 4242 (The Tax Incentive Act of 1981, which was renamed the Economic Recovery Tax Act of 1981), in describing interests that qualify for the gift tax marital deduction under section 2523(f) as qualified terminable interest property, states, in part, at p. 161, "The bill permits the creation or retention of any powers over all or a portion of the corpus, provided all such powers are exercisable only at or after the death of the spouse." See 1981-2 C.B. 378. Moreover, the so-called Blue Book, the *General Explanation of the Economic Recovery Tax Act of 1981 Prepared by the Professional Staff of the Joint Committee on Taxation* (Dec. 29, 1981), p. 235, states, "The Act permits the creation or retention of any powers exercisable in favor of any person over all or a portion of the corpus, provided all such powers are exercisable only at or after the death of the spouse." Thus, when a lifetime QTIP trust is created, it is quite certain that the donor spouse is permitted to make the QTIP election even though he retains a power of appointment that becomes operative after the death of the donee spouse.

Lingering Doubts?

Despite the apparent logic of the conclusion that section 2523(b)(2) applies only with respect to powers of appointment granted to the donor spouse by a third party, that conclusion is not entirely free from doubt. For example, at least for estate tax purposes, a leading commentator, contrary to the statement in *Estate of Halpern*, *supra*, suggests that a self-created power could be taxable under section 2041. Lowndes, Kramer, and McCord, *Federal Estate and Gift Taxes* section 12.1, n.14 (3d Ed. 1974). And the IRS in a private letter ruling indicates that, if a reserved power does not fall within the purview of either section 2036 or section 2038, section 2041 may apply, citing Lowndes, Kramer, and McCord. LTR 8916032 (not precedent). Note also that in 1948, when the marital deduction was enacted, the regulations provided that a self-created power of appointment could trigger estate tax inclusion under the predecessors of both sections 2036(a)(2) and 2041. See reg. section 81.19.

Even assuming that section 2041 could apply to a self-created power, it seems virtually certain that section 2514 could not apply to a reserved power. "For purposes of sections 25.2514-1 through 25.2514-3, the term 'power of appointment' does not include powers reserved by a donor to himself." Reg. section 25.2514-1(b)(2). And like section 2514, section 2523(b)(2) is a gift tax provision.

But note that even the gift tax regulations (both those in effect when the Revenue Act of 1948 was enacted and those in effect now), which exclude from the scope of a power of appointment any reserved power, limit their application to the section under which the regulation was promulgated. That is, for purposes of what is now section 2514, reserved powers are not included. Section 2523(b)(2) is a different section and contains no definition of power of appointment. Moreover, a specific statement in the legislative history to the Revenue Act of 1948 could be construed as suggesting that reserved (that is, self-created) powers are covered by section 2523(b)(2). The statement is, "It is immaterial whether the power so released is a power of appointment within the definition in section 1000(c) of the code." Although section 1000(c), like its successor, section 2514 in the 1986 code, deals with gift taxation with respect to property over which a person holds a general power of appointment, section 1000(c) does mention powers of appointment other than general powers. However, the statement is made in connection with what is now section 2523(b)(1). Moreover, the only definition of a power of appointment in section 1000(c) was a general power, suggesting the statement merely means it applies to nongeneral powers of appointment. In the discussion regarding what is now section 2523(b)(2), it is stated, "The retained power need not be a taxable power of appointment under section 1000(c) [now section 2514] in order to disqualify the interest given to his spouse for the marital deduction." Sen. Rep. No. 1013, pt. 2, 80th Cong., 2d Sess., at 31. That seems to suggest that only powers of appointment (whether or not general powers) created in the donor spouse by someone else fall within the purview of section 2523(b)(2).

Conclusions

Based on the foregoing, it seems nearly certain that section 2523(b)(2) is limited to a power of appointment

granted by someone else to the donor spouse and does not include one that the donor spouse creates in himself. Therefore, the donor of a trust (or similar arrangement) described in section 2523(e) or section 2523(f) may retain the power of disposition over the property in that trust (or similar arrangement) without causing it to fail to qualify for the gift tax marital deduction if the power is exercisable or takes effect only after the death of the spouse who is the beneficiary of the trust or similar arrangement.

Reason for the Rule Is Not Certain

The rule in section 2523(b)(2) seems strange. If a married person receives a terminable interest only over property from another person and no power of appointment, a gift of that interest to the married person's spouse qualifies for the gift tax marital deduction. Hence, if a wife's father gives her a life estate and provides that when she dies it passes to her then-living descendants in *per stirpital* shares, the gift of the life estate she makes to her husband qualifies for the gift tax marital deduction. But if her father also gave her a power to appoint the property among her descendants by her will and, in default of the exercise of the power, it passes to her then-living descendants in *per stirpital* shares, section 2523(b)(2) forecloses the allowance of the marital deduction. It has been stated that the provision was necessary because a power of appointment is not a property right. ("To insure disqualification where the donor retains a power of appointment (*since such a power is not regarded as an interest in property*"), there is an express provision covering such a case." Surrey, "Federal Taxation of the Family — The Revenue Act of 1948," 61(7) *Harvard Law Review* 1097, 1142 (July 1948) (emphasis added).) But that does not seem to explain why the framers of the marital deduction rules drew a distinction between a case in which the donor spouse has been granted a nontaxable power of appointment and one in which none has been granted.