The QTIP Remainder Purchase After Revenue Ruling 98-8

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Sales of remainder interests in assets in which the seller retained a life estate used to be a popular estate planning technique but in the wake of the Federal Circuit decision in the 1987 case of Gradow v. U.S. and Chapter 14 this and related techniques were largely abandoned in recent years. This article discusses the related technique of purchase of a QTIP remainder for its actuarial value by the life income beneficiary, in light of a case that settled in the Tax Court in 1996 and a 1998 revenue ruling that concluded that such a sale constituted a taxable event under §2519. Unlike the classic remainder sale, which involved retention of a life estate by the seller, the QTIP remainder purchase leaves the seller with no interest in the property; the life interest is already held beneficially for the purchaser. The authors discuss in detail the value of revenue rulings as precedent and presents the positions of several courts of appeal on the matter, concluding that the 1998 ruling should not rule out the QTIP remainder purchase as a viable technique of estate planning. For further discussion, see 50 T.M., Transfers with Retained Interests and Powers.

On Sunday, December 22, 1996 the New York Times published a front page story entitled, "For Wealthy Americans, Death Is More Certain Than Taxes." A portion of the story highlighted the case of *Olsten v. Comr.*[1] involving the purchase of the remainder interest in a QTIP trust by the surviving spouse of William Olsten, founder of the nation's third largest temporary help agency. The QTIP trust, created at the death of William Olsten, provided an income interest for the life of Mrs. Olsten with the remainder to pass to William Olsten's children and grandchildren at Mrs. Olsten's death. The New York Times article discussed Mrs. Olsten's purchase of the remainder interest in that QTIP trust for over $55 million from her children and grandchildren.

The QTIP trust consisted primarily of publicly traded Olsten stock and was valued at approximately $73 million prior to the purchase of the remainder interest by Mrs. Olsten. On June 29, 1993 Mrs. Olsten purchased the remainder interest of the trust for $55,458,514, an amount equal to the actuarial value of the remainder interest. Since the entire value of the QTIP trust would be included in Mrs. Olsten's estate, the result of the transaction would be to remove her own assets from her taxable estate without incurring a transfer tax.

On audit, the Service characterized the Olsten transaction as a gift rather than as a purchase for fair and adequate consideration in money or money's worth and asserted deficiencies of over $32 million in gift and generation skipping transfer taxes. As the case was pending in the Tax Court, the Service offered a settlement that Mrs. Olsten and her attorneys accepted. The case was settled for almost $22 million in gift and GST taxes and a stipulated decision was entered on September 20, 1996. The result; Mrs. Olsten transferred $55 million of property that would have otherwise been included in her estate and saved over $10 million in gift and GST taxes in the process.

THE QTIP REMAINDER PURCHASE

This technique, where a surviving spouse reduces his or her estate tax exposure by purchasing the remainder interest in a QTIP trust from the remainder interest owners, has been lurking in the shadows of the estate planning community since at least 1990.[2] However, *Olsten* is the only publicly known case in which the technique was actually implemented.

It is not the intention of the authors to attempt an exhaustive technical discussion of this technique. An abundance of commentators have already done this homework quite well. Those unfamiliar with this technique are encouraged to review the valuable contributions of these commentators.[3] The authors intend instead to discuss some of the core issues of controversy and focus on whether or not the technique remains viable after the government's publication of Revenue Ruling 98-8 [4] which warns practitioners and taxpayers that the technique is contrary to existing tax law.

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[1] United States Tax Court Docket No. 22277-95, stipulated decision entered September 20, 1996.

[2] *See* 24 Heckerling Inst. on Estate Planning ¶¶2002-2002.5 (1990).

[3] *See* Bettigole, "Can a Surviving Spouse Reduce Estate Taxes by Purchasing the QTIP Trust Remainder Interest?," 76 *Journal of Taxation* 132 (March 1992); Zuckerman and Soled, "QTIPs Tax Benefits Increased by Sale of Remainder Interest," 19 *Estate Planning* 346 (November-December 1992); Bettigole, "Can The Olsten Scenario Save Estate Taxes?," 134 *Trusts & Estates* 46 (February 1995); Hesch, Gopman and Kaplan, "Purchasing the Remainder Interest in a QTIP Trust — An Analysis of Olsten v Commissioner," 21 *Tax Management Estates, Gifts and Trusts Journal* 122 (May-June 1996); Kaplan, "The Purchase of the Remainder Interest in a QTIP Trust by the Income Beneficiary," 22 *Tax Management Estates, Gifts and Trusts Journal* 139 (May-June 1997).

[4] 1998-7 I.R.B. 24 (2/17/98).

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BEFORE REVENUE RULING 98-8

Although a number of technical risks had been identified as potential pitfalls in implementation of the QTIP remainder purchase, §2519 was recognized by most estate planners as the primary and most troublesome concern with regard to the propriety of this technique. Section 2519(a) provides that "any disposition of all or part of a qualifying income interest for life in any property to which this section applies shall be treated as a transfer of all interests in such property other than the qualifying income interest." Additionally, §2519(b) continues that "this section applies to any property if a deduction was allowed with respect to the transfer of such property to the donor under §2056 by reason of subsection (b)(7) thereof. . . "

Proponents of the QTIP purchase distinguished the application of §2519 from the mechanics of the technique by focusing on the fact that a purchase of a remainder interest represented a transaction qualitatively different from a "disposition" of an income interest. This argument is not unpersuasive. Section 2519 does not offer a definition of the term "disposition." Black's Law Dictionary defines the term as "[the] act of disposing; transferring to the care or possession of another . . . the parting with, alienation of, or giving up property." [5] The purchase of a remainder interest results in the acquisition of property. This is mutually exclusive from the "giving up of property." Moreover, if the owner of an income interest in property purchases its remainder interest, that owner has not parted with enjoyment of the property's income interest.

Despite the uncertainty of the application of §2519, Mrs. Olsten's estate planners were convinced that the technique worked. Mrs. Olsten purchased the remainder interest in her QTIP trust. Although not convinced that the technique worked, the Service apprently was not convinced that the technique *did not* work. As a result, by settling the controversy with Mrs. Olsten, the Service could be viewed as having abandoned $10 million in transfer tax revenue to avoid the possibility of an adverse Tax Court decision on the issue.

REVENUE RULING 98-8

Early in 1998, the Service issued Revenue Ruling 98-8 to combat the QTIP remainder purchase technique. The ruling represents a full frontal assault on the technique, utilizing §2519 as the principal weapon. In its ruling, the Service undertakes the task of parsing the term "disposition" in §2519 in such a way so as to include the purchase of a remainder interest in a QTIP trust within its meaning.

In extending the term "disposition" to include the purchase of a remainder interest, the Ruling relies on the analysis of a commutation. The ruling points to Treasury Regs. §25.2519-1(f) which provides that "the 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." [6] Consequently, a §2519 "disposition" would include a commutation of the surviving spouse's income interest in the QTIP trust.

After establishing that the term "disposition" comprehends a commutation of the surviving spouse's income interest the ruling concludes that "[t]here is little distinction between the sale and commutation transactions treated as dispositions in the regulations and the transaction presented here, where [the surviving spouse] acquired the remainder interest." [7] The ruling argues that the QTIP remainder purchase represents a constructive commutation of the surviving spouse's income interest, since after either the commutation of the income interest, or the QTIP remainder purchase the surviving spouse receives ownership of property having a net value equal to the value of the surviving spouse's income interest. As a result, the QTIP remainder purchase "essentially effectuates a commutation of [the surviving spouse's] income interest in the trust, a transaction that is a disposition of [the surviving spouse's] income interest." [8]

Still, it might seem troubling to some that the QTIP remainder purchase is characterized as a commutation of the surviving spouse's income interest. This is because although the purchase of the remainder interest by an income interest owner might look like a commutation, it may not be one. Although a merger of the income and remainder interests may compel termination of the QTIP trust under local law, the doctrine of merger will not apply if termination of the QTIP trust would defeat a material purpose of the trust.[9] Additionally, from the standpoint of a literal interpretation of commutation, the Service in its ruling defines commutation as "a proportionate *division* of trust property between the life beneficiary and remainderman based on the respective values of their interests." [10] Like the terms acquisition and disposition, the terms merger and division should be mutually exclusive.

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[5] Black's Law Dictionary, 6th Edition, *West Publishing Company* (1998).

[6] Although Regs. §25.2519-1(f) did not become a final regulation until March 1, 1994, it existed as a proposed regulation at the time of the Olsten QTIP purchase.

[7] Above note 4.

[8] *Id.*

[9] Scott on Trusts, 4th Edition, §341.

[10] Above note 4 (emphasis added).

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AFTER REVENUE RULING 98-8

Now that Revenue Ruling 98-8 has been issued, concluding that the QTIP remainder purchase constitutes a prohibited "disposition" of the surviving spouse's income interest under §2519, are taxpayers prospectively foreclosed from successfully employing this technique? Not necessarily.

Revenue rulings are published disclosures of IRS positions concerning hypothetical fact patterns. These rulings are based upon the IRS' interpretation of the tax laws as they relate to the specified fact patterns and are intended to provide guidance to taxpayers.[11] Unlike Treasury regulations, which are subject to procedures that give notice of their issuance in proposed form and solicit commentary from the public,[12] revenue rulings are generally issued without giving notice or soliciting comments unless special circumstances are involved.[13]

In determining the merits of a position with regard to tax litigation, there appears to be a great deal of confusion among the courts as to the weight that should be given revenue rulings.[14] The Tax Court has taken the position that "revenue rulings are *merely the interpretation of one of the parties to the litigation and are not given precedential effect.*" [15] Moreover, the Tax Court has consistently followed this practice of eschewing judicial deference to revenue rulings.[16]

By contrast, courts of appeal have been inconsistent with respect to their respective positions on deference to revenue rulings both within and across circuits.[17] Similar to the Tax Court, courts of appeal in general have historically taken the position that revenue rulings are not binding on the courts.[18] However, more recent decisions indicate that a few of the courts of appeal have wavered from their traditional position and moved toward a position that gives more weight to revenue rulings, with no explanations for the inconsistencies. Conversely, a small number of courts of appeal are holding to their practice of non-deference to revenue rulings. In short, the success of a position in tax litigation that relies on the authority of a revenue ruling depends largely on choice of forum.

The Supreme Court has taken a conspicuously silent position with respect to the proper amount of deference that revenue rulings are due.[19] Consequently, courts of appeal are left to their own judgement as to what, if any, deference is to be afforded revenue rulings.

It has been suggested that the reason the courts of appeal may be more inclined to give deference to revenue rulings than the Tax Court is due to the generalist nature of the courts of appeal, as opposed to the more specialized nature of the Tax Court.[20] However, it has also been noted that the traditional practice of the courts of appeal has been to give deference to the Tax Court where possible.[21] Curiously, several courts of appeal have digressed from this approach as well in recent years when revenue rulings are involved.

Last year the Fifth Circuit Court of Appeal wrestled with the issue of revenue rulings and the degree of deference that they should be afforded. In *McLendon Est. v. Comr.*,[22] the Service encouraged the court to "ignore or minimize" the effect of one of its revenue rulings because it was contrary to its own litigation position.[23] This fact was not lost on the court which seemed irritated that "the argument to ignore or minimize the effect of [the revenue ruling] comes from the Commissioner, the *very party who issued the ruling in the first place.*" [24] The Fifth Circuit declined to permit the Service to deviate from its position in the revenue ruling and held in favor of the taxpayer.

In *McLendon*, the Fifth Circuit both noted the Tax Court's longstanding practice of ignoring the precedential value of revenue rulings and acknowledged the ambiguity of their precedential value.

> Still, revenue rulings are odd creatures unconducive to precise categorization in the hierarchy of legal authorities. They are clearly less binding on the courts than treasury regulations or Code provisions, but probably (and in this circuit certainly) [25] more

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[11] Regs. §601.601(d)(2)(i).
[12] Regs. §601.601(b)(1).
[13] Regs. §601.601(d)(2)(v)(f).
[14] *See* Galler, "Judicial Deference to Revenue Rulings: Reconciling Divergent Standards," 56 *Ohio St. L.J.* 1037 (1995).
[15] *Geisinger Health Plan v. Comr.*, 100 T.C. 394, 405 (1993). (Emphasis added).
[16] *Krumhorn v. Comr.*, 103 T.C. 29, 43 n. 20 (1994); *Exxon Corp. v. Comr.*, 102 T.C. 721, 726 n.8 (1994); *Hubert Est. v. Comr.*, 101 T.C. 314, 325 (1993); *Halliburton Co. v. Comr.*, 100 T.C. 216, 232 (1993); *Vulcan Materials Co. v. Comr.*, 96 T.C. 410, 418 (1991).
[17] Galler, above note 14, at 1061.
[18] *See, e.g., Julia R. & Estelle L. Found. Inc. v. Comr.*, 598 F.2d 755, 757 n. 3 (2d Cir. 1979); *Babb v. Olney Paint Co.*, 764 F.2d 240, 242 (4th Cir. 1985); *Stubbs, Overbeck & Associates, Inc. v. U.S.*, 445 F.2d 1142, 1147 (5th Cir. 1971); *Mercantile Bank & Trust Co. v. U.S.*, 441 F.2d 364, 368 (8th Cir. 1971); *Bolker v. Comr.*, 760 F.2d 1039, 1043 (9th Cir. 1985).
[19] Although the Supreme Court has not elucidated the subject of deference concerning revenue rulings, Justice O'Connor, through her concurring opinion in *Hubert Est. v. Comr.*, 117 S.Ct. 1124, 1134 (1997), has suggested that the Service is bound by revenue rulings in its litigation positions. The Fifth Circuit Court of Appeal in *McLendon* recently indicated that it agrees with Justice O'Connor's suggestion. Below note 22.
[20] Galler, above note 14 at 1077.
[21] *Id.* at 1084.
[22] 135 F.3d 1017 (5th Cir. 1998).
[23] *Id.* at 1023.
[24] *Id.* (Emphasis added).
[25] The presence of this parenthetical aside would indicate that the Court was aware that revenue rulings have been afforded varying degrees of deference in other circuits, further confusing the matter.

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> so than the mere conclusions of legal parties. Apart from that, little can be said with any certainty, and in the absence of a definitive statement from on high, the Tax Court continues its crusade to ignore them in toto.[26]

The court further elaborated on the Tax Court's "battle" with various courts of appeals highlighting the difference between the Tax Court's staunch view on the irrelevance of revenue rulings in tax litigation and the practice of some circuits of the courts of appeals in extending revenue rulings some degree of deference.

> We note at the outset that the Tax Court has long been fighting a losing battle with the various courts of appeals over the proper deference to which revenue rulings are due. Whereas virtually every circuit recognizes some form of deference,[27] the Tax Court stands firm in its own position that *revenue rulings are nothing more than the legal contentions of a frequent litigant, undeserving of any more or less consideration than the conclusory statements in a party's brief.* [28]

Rather than simply making conclusions based on the existence of a revenue ruling, the court in *McClendon* is the first among all of the courts of appeal to openly discuss the subject of revenue rulings and their proper role in evaluating a position in tax litigation. The court also observed the Supreme Court's lack of guidance on the issue of revenue rulings and their precedential value. In an apparent admission to the possibility that maybe the Tax Court had extended more effort in understanding the issues surrounding the amount of deference that revenue rulings should be afforded, the court determined that "given the context, this omission [by the Supreme Court] cautions against placing too much reliance on revenue rulings as administrative legal interpretations, and the position of the Tax Court is not without some merit." [29]

Unfortunately, after acknowledging the confusion concerning the role of revenue rulings, the Fifth Circuit abdicated from making any decisions that might clear up the uncertainty. Since the Service, rather than the taxpayer, was the party in *McLendon* arguing that its revenue ruling should be ignored the court found it much more convenient to bind the Service to its ruling under Regs. §601.601(e) which provides that taxpayers may rely on published revenue rulings in determining the tax treatment of their own transactions. If instead it had been the taxpayer arguing to ignore the revenue ruling as contrary to law, the issue of deference would not have been as easy to bypass. Seemingly relieved, the court noted that the case presented in *McLendon* "does not require us to step squarely into the fray." [30] Consequently, the issue of judicial deference to revenue rulings where the ruling benefits the position of the Service was left for another day.

The inconsistency in deferential standards exists not merely between the Tax Court and the courts of appeal but among the courts of appeal themselves, and in many cases, between panels within individual circuit courts.[31]

In light of the confusion surrounding the actual weight to be accorded revenue rulings, it seems troubling that courts of appeal would give unexamined deference to them in lieu of a decision based upon a thorough review of the facts and law. Revenue rulings may be understandably seen as biased due to the fact that they are issued by the Service, the executive branch agency charged with the collection of tax revenue, without any comment or scrutiny by the public. For a federal court to accept their authority carte blanche would represent a disturbing rejection of judicial impartiality. It has been observed that in according deference to revenue rulings federal courts would encourage the Service to issue revenue rulings for the obvious purpose of ensuring its own later success in litigation.[32] Moreover, by giving deference to revenue rulings, the courts would essentially elevate the status of revenue rulings to be equivalent to that of Treasury regulations, which is clearly inconsistent with the language of Regs. §601.601.

Based on the Fifth Circuit's discussion of this issue in *McLendon* however, there is an indication that the Tax Court's standard of ignoring revenue rulings as authority in and of themselves, which is arguably the correct standard, may be formally adopted by some of the federal courts of appeal if not the Supreme Court. Until such time as the federal courts of appeal adopt some uniformity in their approach to the precedential value of revenue rulings, choice of forum analysis will be critical for taxpayers who want to maintain a tax position premised in the law, but contrary to a revenue ruling. The Tax Court will gladly entertain the merits of a taxpayer's position based in law while subject to an adverse revenue ruling. However, the appeal of a Tax Court decision by the Service in these situations may yield uncertain results in the various federal courts of appeal.

CONCLUSION

The issuance of Revenue Ruling 98-8 should not represent the death knell of the QTIP remainder

[26] *McClendon Est. v. Comr.*, 135 F.3d at 1023.
[27] It is arguable that there are some circuits that afford very little deference to revenue rulings. For example, the Court of Appeals for the Tenth Circuit gives very little weight to revenue rulings. Galler, above note 14 at 1085.
[28] *McClendon Est. v. Comr.*, 135 F.3d at 1023.
[29] *Id.* at 1024, n. 12.
[30] *Id.* at 1023.
[31] Galler, above note 14 at 1061.
[32] *Id.* at 1040.

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purchase. The ruling's contemplation and analysis of law with respect to the QTIP remainder purchase does not disclose any significant or surprising new developments for those who have advocated the QTIP purchase as a viable estate planning technique.

For those who believe that the QTIP purchase would work for Mrs. Olsten, it should still work for other taxpayers. If, or more likely when, the transaction is next challenged by the Service, the Tax Court will provide the taxpayer with an impartial forum to review the merits of the position unprejudiced by the existence of Revenue Ruling 98-8. Whether or not Revenue Ruling 98-8 may represent an impediment to the success of the QTIP purchase on appeal from the Tax Court will depend largely on which circuit court of appeal subsequently hears the controversy.

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