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INTERNAL REVENUE SERVICE
TECHNICAL ADVICE MEMORANDUM

Taxpayer's Name:
Taxpayer's ID Number:
Taxpayer's Address:

Date of Transfers:
District Director:

LEGEND:

Decedent=
Spouse =
C =
D =
Corporation =
Trust =
$r =
$s =
$t=
$u =
$w =
$x =
$y =
$z =

Issue:

Assuming that trustees' fees paid to C and D, the surviving spouse's two children, in their capacity as trustees of a qualified terminable interest property (QTIP) trust, are excessive for purposes of §§ 162 and 212 of the Internal Revenue Code, does the payment of such fees constitute taxable gifts to C and D under § 2501?

Conclusion:

Assuming the payments are determined to be excessive, we conclude that, by acquiescing in the payment of excessive trustee fees to C and D, Spouse has made transfers that constitute taxable gifts under § 2501, to the extent the fees were excessive.

FACTS:

On June 3, 1988, Spouse and Decedent entered into a revocable trust agreement creating Trust. The original trustees of Trust were the two children of Spouse and Decedent, C and D, and two other unrelated individuals. Since that time, the unrelated parties have resigned as trustees, leaving C and D as the remaining trustees.

On July 7, 1988, Decedent died. Under the terms of Trust, Decedent's community property share of the trust corpus was divided into two trusts, Trust A, a credit shelter trust, and Trust B, a trust intended to qualify as qualified terminable interest property (QTIP) under § 2056(b)(7). Under the terms of Trust B, the trustees are to pay, at least annually, the net income of Trust B to Spouse, during her lifetime. The trustees also have a discretionary power to distribute principal "up to the whole thereof" for Spouse's support, health, maintenance, and education. Upon Spouse's death, Trust B is to terminate and the trust property is to be distributed to Trust C, for the benefit of C and D, and their children.

Spouse, as executrix of Decedent's estate, filed Form 706. The gross estate reported was $x. The primary asset of the estate was approximately 42.5% of the stock of Corporation, a closely held corporation. The estate elected to treat Trust B as QTIP under § 2056(b)(7) and claimed a marital deduction of $y for the property transferred to the trust, consisting primarily of Decedent's interest in Corporation.

On June 30, 1989, all of the common stock of Corporation was sold to an unrelated party for $z. According to the taxpayer, because of their knowledge of the operations of Corporation, C and D acted as the company's broker in the sale of the company.

After the sale of Corporation, the trust assets were invested primarily in treasury bills. Since 1989, these securities have comprised approximately 80% of the Trust B assets.

In 1992, the purchasers of Corporation filed for bankruptcy protection. In July 1994, the trustee in bankruptcy for Corporation initiated a lawsuit against Trust, the decedent's estate, Spouse, C and D, alleging certain causes of action relating to the 1989 sale of Corporation. It is represented that C and D worked extensively with the attorneys hired to defend the lawsuit.

From 1991 through 1997, C and D were each paid trustee fees of $w per year from Trust B. The fees were characterized as salaries deductible under § 162 (as opposed to administration expenses deductible under § 212).

The "salaries" of $w per year for each of C and D were apparently agreed to by C, D, and Spouse after consulting with a "trust attorney." The agreement was verbal and never formalized in writing.

In each taxable year of Trust B at issue, the trust's expenses exceeded the trust's income. Accordingly, Spouse has not received any income from Trust B. The Forms 1041 filed for the trust do not reflect any principal distributions to Spouse.

The Internal Revenue Service examined the Forms 1041 filed by Trust B for 1994, 1995, and 1996. The Service concluded that the deduction for the salaries/trustees' fees should be reduced because the salaries/fees paid to C and D with respect to Trust B were in excess of what would be characterized as "reasonable" for purposes of §§ 162 and 212. The fee deduction was reduced to $s (1994), $t (1995) and $u (1996). The revenue agent made inquiries to banks in the area to determine what a bank would charge as a trustee fee for a trust of approximately the value of Trust B, that consisted largely of treasury bills. It was determined that a bank would charge approximately $r per year for managing assets of this nature. The $r amount is 5% of the total fees paid to C and D.

The taxpayer contends that C and D were serving in fiduciary or management capacities for other trusts and entities including Spouse's Living Trust, Spouse's Irrevocable Insurance Trust, a private foundation established by Decedent and Spouse, and Spouse's Irrevocable Grandchildren's Trust. The fees paid to C and D from Trust B, included payment for the services rendered by C and D to those entities, as well as the services provided to Trust B.

LAW AND ANALYSIS:

Section 2056(a) provides that, for purposes of the tax imposed by § 2001, the value of the taxable estate is to be determined by deducting from the value of the gross estate an amount equal to the value of any interest in property that passes or has passed from the decedent to the surviving spouse.

Section 2056(b)(7) provides that, in the case of qualified terminable interest property, the property shall be treated as passing to the surviving spouse for purposes of § 2056(a) and no part of the property shall be treated as passing to any person other than the surviving spouse.

Under § 2044, any property subject to an election under § 2056(b)(7), for which a marital deduction was allowed, is includible in the gross estate of the surviving spouse.

Section 2501 provides that a tax is imposed for each calendar year on the transfer of property by gift during such calendar year by any individual, resident or nonresident.

Section 2511 provides that the tax imposed by section 2501 applies whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible. Section 25.2511-1(c)(1) of the Gift Tax Regulations provides that any transaction in which an interest in property is gratuitously passed or conferred on another, regardless of the means or device employed, constitutes a gift subject to tax.

Section 2512(b) provides that, where property is transferred for less than adequate consideration in money or money's worth, the excess of the value of the property over the value of the consideration shall be deemed a gift.

Section 25.2512-8 excepts from the application of the gift tax "a sale, exchange, or other transfer of property made in the ordinary course of business (a transfer that is bona fide, at arm's length, and free from any donative intent)."

In Commissioner v. Wemyss, 324 U.S. 303, 306 (1945), the Supreme Court concluded that Congress intended to use the term "gifts" in its broadest and most comprehensive sense. The Court noted the "evident desire of Congress to hit all the protean arrangements which the wit of man can devise that are not business transactions within the meaning of ordinary speech.....Thus, on finding that a transfer in the circumstances of a particular case is not made in the ordinary course of business, the 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."

Although § 25.2512-8 excepts ordinary business transactions from the application of the gift tax, transactions within a family group are subject to special scrutiny, and the presumption is that a transfer between family members is a gift. Harwood v. Commissioner, 82 T.C. 239, 259 (1984). Estate of Reynolds v. Commissioner, 55 T.C. 172 (1970). "The pertinent inquiry for gift tax purposes is whether the transaction is a genuine business transaction, as distinguished from the marital or family type of transaction involved in Wemyss and its companion case, Merill v. Fahs, 324 U.S. 308." Estate of Anderson v. Commissioner, 8 T.C. 706, 720 (1947).

In Estate of Hendrickson v. Commissioner, TCM 1999-357, the surviving spouse was bequeathed a substantial portion of the decedent's estate. The estate was subject to a prolonged period of administration during which the court determined the spouse was entitled to receive approximately $913,000 in estate income. However, most of this income was diverted to, or expended for the benefit of the other beneficiaries of the estate (the spouse's children.) The court held that the spouse's conduct as personal representative of the estate and her acquiescence in the expenditure of estate income that she was otherwise entitled to receive for the benefit of her children, constituted a gift for gift tax purposes.

In the present case, we believe that the fees, to the extent they were excessive, constitute gifts by Spouse to C and D. The trustees' fees were paid by agreement of Spouse, to her two children, the natural objects of her bounty. There is no evidence of any arm's length bargaining regarding the setting of the fees, and little evidence of a good faith effort to determine the appropriate fee amount, at least on an ongoing basis. The income tax examiner has determined that there is a substantial disparity between the fees paid and that which would constitute a reasonable fee. Thus, there is no indication that the setting of the trustees' fees and the subsequent payment should be viewed as a transaction in the ordinary course of business. Spouse is the income beneficiary of Trust B. As was the case in Estate of Hendrickson, cited above, Spouse's agreement to, and acquiescence in, the payment of excessive fees effectively diverted to her children trust income she was otherwise entitled to receive. We believe the facts (including the substantial disparity between a reasonable fee and the fees actually paid) support the conclusion that the excessive fees were intended by all the parties involved to facilitate Spouse's estate plan by transferring assets that would otherwise be subject to estate tax in Spouse's gross estate to Spouse's children without the payment of transfer tax.

In response, the taxpayer cites Saltzman v. Commissioner, 131 F. 3d 87 (2nd Cir. 1997). In Saltzman, the taxpayer who owned almost all of the stock of MBI corporation, created four irrevocable trusts for the benefit of two of his three children and his two grandchildren. The taxpayer and his accountant were the co-trustees of the trusts and were also directors of MBI. Without prior court approval or knowledge of the trust beneficiaries, taxpayer recapitalized MBI. The four trusts' MBI common stock was exchanged for preferred stock with a lesser value. The taxpayer's son, who was also a shareholder of the corporation but not a beneficiary of the trusts, received all of the common stock of MBI. The court held that the grantor\trustee's recapitalization of the corporation shifting significant value from the trusts to the son was not a gift by the taxpayer\trustee because a trustee cannot be viewed as making a gift in performing fiduciary duties, even if the acts at issue were improper. Rather, to the extent the trustee made improper distributions, a constructive trust would arise in favor or the trust beneficiaries.

The taxpayer contends that the facts in the present case are similar to those of Saltzman. The taxpayer argues that, based on Saltzman, if the trustees paid themselves excessive fees, the surviving spouse, as the current beneficiary of the trust retains an interest in the property transferred and a constructive trust arises.

However, in the present case, the current beneficiary of the trust (Spouse) had agreed to the payment of the excessive fees to the C and D. This situation where the trustees acted with consent of the beneficiary must be distinguished from the situation presented in Saltzman, where the trustee in dealing with the trust property on his own account acts without consent of the beneficiaries. Where the beneficiaries do not consent, the transaction is voidable by them even though the trustee acted in good faith. Where the beneficiaries consent to the transaction, it is voidable only if the trustee failed to disclose to the beneficiaries the material facts that he knew or should have known, or if he used the influence of his position to induce the consent, or if the transaction was not in all respects fair and reasonable. See, Scott on Trusts, section 170, (4th ed. 1988). Accordingly, in the present case, it is doubtful whether the payment of the excessive trustees' fees is voidable such that a constructive trust would arise to effectively "undo" the excessive payments.

We conclude that assuming the fees were excessive, then the fee payments, to the extent excessive, were not transfers in the ordinary course of business within the meaning of § 25.2512-8, and were not transfers made for an adequate and full consideration in money or money's worth under § 2512(b). Rather, the transfers constitute taxable gifts by Spouse in each year, to the extent that the fees paid are determined to be excessive.

After careful consideration, we have determined that § 2519 is not applicable in the instant case.

Caveat:

A copy of this technical advice memorandum is to be given to the taxpayer. Section 6110(k)(3) provides that it may not be used or cited as precedent.

- END -