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INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR ASSOCIATE AREA COUNSEL, SB/SE Area 8
CC:SB:8:LA:2
Attn: Irene S. Carroll

FROM: Paul F. Kugler
Associate Chief Counsel (Passthroughs and Special Industries) CC:PSI

SUBJECT: Assets Includible in Decedent's Gross Estate

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LEGEND

Decedent =

A =

B =

Daughter =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Trust =

$a =

$b =

$c =

$d =

$e =

Year 1 =

Year 2 =

Foundation =

State X =

ISSUE

To what extent are assets that were not reported on the estate tax returns filed for the estates of Decedent and Decedent's pre-deceased spouse, A, includible in Decedent's gross estate?

CONCLUSION

Based on the current information, and as discussed more fully below, it appears that assets will be includible in Decedent's gross estate under §§ 2033, 2036, 2038, and 2044.

FACTS

The documents submitted indicate the following. Decedent and A, wife and husband, were residents of State X, a community property state. A, died on Date 1, survived by Decedent. Approximately nine months later, on Date 2, Decedent died.

It appears that Decedent and A created Trust, a revocable trust, on Date 3, and that Trust was amended many times during their lifetimes. Apparently, copies of all amendments are not currently available. Based on the documents received, the Fourth Amendment, signed on Date 4, amends and restates the terms of Trust. Comments are based on the assumption that the Fourth Amendment contains the significant relevant provisions in effect at Decedent's death.

Decedent and A were the Trustors and the Trustees of Trust. Article 3.01 provides that during the lifetime of both Trustors, the community estate may be withdrawn in whole or in part by either Trustor, and any separate estate may be withdrawn in whole or in part by the Trustor who created it. The Trustors reserve the right to alter or amend the Trust in whole or in part at any time during the lifetime of both Trustors.

Article 4.01 provides that, so long as both Trustors are living, the Trustee shall pay to the Trustors, or shall apply for their use or benefit, the entire net income of the community estate, and shall pay to or apply for the benefit of each Trustor the entire net income from any separate estate held for him or her. The Trustors may withdraw the principal of the community estate, and any Trustor who created a separate estate may withdraw the principal of the separate estate.

Article 6.01 provides that the Trustors may use and occupy any principal residence contributed to Trust without the payment of rent, and that the trustee will pay from the income or principal of Trust, any taxes, assessments, fire and casualty insurance and reasonable improvements for such home. If the Trustee sells the residence, the proceeds of such sale may be used to purchase, acquire, or build a substantially similar home and allow the Trustors to occupy the new home under the same terms.

Under Article 4.02, upon the death of one Trustor survived by the other Trustor, the Trustee is to divide Trust into Trust A, Trust B, and Trust C. Trust A consists of the surviving Trustor's share of the community property, including that received by the Trustee upon or by reason of the death of such Trustor, and the surviving Trustor's separate property, if any, including any proceeds from life insurance or employee benefit plans owned by the surviving Trustor. The balance of the Trust assets, consisting of the deceased trustor's community and separate property passes to Trust B and Trust C. Trust B is described as a "credit shelter" trust to be funded with that amount that can pass free of estate tax by reason of the applicable unified credit. The balance of Trust assets pass to Trust C, a qualified terminable interest property (QTIP) trust, intended to qualify for the marital deduction under § 2056(b)(7).

Under Article 3.02 of Trust, from and after the death of the first Trustor to die, the surviving Trustor has the power to alter, amend or revoke Trust A (described below) in whole or in part, but Trust B and Trust C (described below) may not be altered, amended or revoked. From and after the death of the surviving Trustor, Trust A may not be altered, amended or revoked by any person.

With respect to Trust A, under Article 4.03, the surviving Trustor receives income and retains the right to withdraw all or any part of the principal at any time. The surviving Trustor has a testamentary general power of appointment over Trust A. With respect to Trust B and Trust C, under Articles 4.04 and 4.05, the surviving Trustor is entitled to all income, but may only invade principal based on an ascertainable standard. On the death of the surviving Trustor, the Trustee may, in its discretion, pay out of the principal of Trust B the surviving Trustor's last illness and funeral expenses, attorney's fees and other costs of probate, bona fide debts, and any estate and inheritance taxes. After both Trustors' deaths, the Trustee shall hold, administer and distribute the balance of Trust B and Trust C, and any portion of Trust A not disposed of under the general power of appointment, to Foundation, an organization described in § 501(c)(3), or if Foundation does not so qualify, to such other organization as may qualify.

Article III of Decedent's will directs her executor to pay all legal debts and provides that if the residuary assets are insufficient to satisfy such obligations, the obligations are to be satisfied from Trust's corpus. Article V provides that the distribution of the “rest, residue and remainder of Decedent’s estate of every kind or nature and wherever situated, including property over which [Decedent’s has] a power of appointment, to the Trustee of [Trust].”

A’s Form 706 (United States Estate (and Generation-Skipping Transfer) Tax Return) was signed on Date 5, and reported a gross estate of $a. A’s Form 706 contained vague references to three parcels of real estate. The return reported that $d in pecuniary bequests passed to A’s brothers, sister, and daughters. On Schedule M of Form 706, A’s executor claimed a marital deduction of $e representing A’s “entire estate” other than the $d in pecuniary bequests. A’s Form 706 did not contained any reference to Trust, or Trusts A, B and C.

Shortly after Date 5, Decedent’s Form 706 was filed reporting a gross estate of $b. With few exceptions such as a life insurance policy payable to Decedent, the assets reported on Decedent’s Form 706 were the same as those reported on the Form 706 filed on behalf of A. However, in some cases, the entire asset was reported whereas on A’s return only A’s one-half community interest was reported. In other cases, the values reported on Decedent’s return were increased over the values reported on A’s return. After the examination of Decedent’s return, Decedent’s executor agreed to an additional assessment. In the course of pursuing collection on the assessment, multiple additional assets, including several significant parcels of real estate, were identified and it was determined that the estate should be re-examined. Upon further examination, it was discovered that personal financial statements executed by A in Year 1 and Year 2 showed a net worth exceeding $c. Further research uncovered multiple holding companies for many parcels of real property and circumstances that appeared to indicate a pattern of tax avoidance and fraud.

It is believed that the Decedent’s estate intentionally misrepresented the nature and value of the assets listed on the Form 706 and intentionally omitted significant other assets. The statutory notice of deficiency includes in the gross estate eight parcels of real estate not included on Decedent’s Form 706, as well as stock in closely held entities, money market accounts, bonds, bank accounts, etc. B is the executor of Decedent’s estate and was also the executor of A’s estate. In addition, B was Decedent and A’s attorney for many years and it appears that B was involved in most, if not all, of the transactions with A either by structuring the transaction or actually participating as a principal in the transaction itself.

Based on § 6501(e)(2), you have proceeded on the belief that the estate omitted assets worth over 25% of the gross estate stated in the return and, therefore, a 6-year statute of limitations applies. In addition, based on the facts and circumstances, you believe that it is likely that under § 6501(c) estate tax may be assessed at any time because it is believed that a false return was filed with the intent to evade tax or because the estate willfully attempted to evade tax.

LAW AND ANALYSIS

Section 2031(a) provides that the value of the gross estate of a decedent is determined by including the value at the time of decedent's death of all property, real or personal, tangible or intangible, wherever situated. Sections 2033 through 2046 list the various ways in which property may be brought into the gross estate under § 2031.

Section 2033 provides that the value of the gross estate shall include the value of all property to the extent of the interest thereof of the decedent at the time of decedent's death. Thus, § 2033 requires the "ownership" of an interest in property by the decedent at the time of the decedent's death.

Sections 2036 through 2038 differ from § 2033 in that each requires a transfer by the decedent during life before the section is applicable. The focus of these sections is situations in which the decedent transferred property while retaining enough control, rights, or benefits from that property that, in substance, the decedent is still considered to own the property and therefore the property is includible in the decedent's gross estate. Section 2036 provides for the inclusion of transferred property with respect to which the decedent retained the income or the power to designate who shall enjoy the income. Section 2037 includes in the decedent's gross estate certain transfers under which the beneficial enjoyment of the property could be obtained only by surviving the decedent. Section 2038 provides for the inclusion of transferred property if the decedent had at the time of decedent's death the power to change the beneficial enjoyment of the property. It should be noted that there is a considerable overlap in the application of sections 2036 through 2038 with respect to reserved powers, so that the transferred property may be includible in the decedent's gross estate in varying degrees under more than one of those sections.

Section 2056(b)(7) allows a marital deduction for qualified terminable interest property. In general, qualified terminable interest property is property with respect to which the surviving spouse receives a qualifying income interest for life and with respect to which the estate makes an election described in § 2056(b)(7)(B)(v) to treat the property as deductible. In general, the spouse has a qualifying income interest for life if the spouse is entitled to receive all the income from the property for the spouse's life, and no person has a power during the spouse's life to appoint the property to any person other than the spouse.

Section 2044 provides for the inclusion in the decedent's surviving spouse's gross estate of any property in which the surviving spouse had a qualifying income interest for life and with respect to which a deduction was allowed to the decedent's estate with respect to the transfer of property to the surviving spouse under § 2056(b)(7).

Based on the information submitted, we cannot provide specific advice on an asset by asset basis. However, we believe it is first necessary to identify how the assets were titled (e.g., A's name, Decedent's name, or in the name of the Trust) and determine how the assets devolved based on the terms of Decedent's and A's wills, and the terms of Trust.

The file did not contain a copy of A's will. However, we note that in many cases where a husband and wife establish a revocable trust to administer their assets, it is common that each will provides for distribution of the probate residuary estate to the revocable trust. Thus, possibly, any excluded assets titled in A's name, would have passed under his will to Trust. However, this would have to be confirmed by examination of A's will.

Any property listed on Decedent's Form 706 or discovered during the re-examination that is titled in Decedent's name are includible under § 2033 to the extent of Decedent's interest at the time of her death.

The documents submitted indicate that the properties omitted from Decedent's Form 706 appear in large part to have been assets owned or title in the name of Trust. Assuming these assets were held in Trust at the time of A's death, the assets should have passed under the terms of Trust. It appears from A's Form 706 that Trust B, the credit shelter trust would not be funded (or would be funded with a minimal amount) since most of the available unified credit was exhausted by pecuniary bequests to A's brothers, sister, and daughters. Thus, the excluded assets titled in the name of Trust should have passed to Trust A and Trust C. To the extent the excluded assets were Decedent's separate property or Decedent's community property, the assets should have passed to Trust A. Trust A assets are subject to inclusion in Decedent's gross estate under §§ 2036 and 2038.

The balance of the assets (including any excluded assets titled in A's name that passed to Trust under the terms of A's will) should have passed to Trust C. These assets would be subject to inclusion under § 2044, if A's estate made the election under § 2056(b)(7)(B)(v) to treat the trust as qualified terminable interest property. In this regard, Schedule M of Form 706 filed for A's estate claimed the marital deduction for his "entire estate," except for pecuniary bequests in the amount of $d, which language would include the assets passing to Trust C.

We emphasize, however, that in general, the pertinent facts must be ascertained before a clear determination can be made as to which Code provision requires inclusion of the assets in Decedent's gross estate.

It also appears that some assets were transferred to various entities over time, generally without any consideration. Still other assets appear to have been transferred shortly before Decedent's death in an attempt to exclude the assets from Decedent's gross estate. In one instance, it appears that Daughter, without authority, transferred, or attempted to transfer, assets out of Trust shortly before Decedent's death.

It is a well established legal principle that the form of a transaction will be recognized for federal tax purposes only if it comports with the substance of the transactions. See Knetsch v. United States, 364 U.S. 361 (1960); Gregory v. Helvering, 293 U.S. 465 (1935). In appropriate situations, the courts have demonstrated a willingness to disregard transfers undertaken to avoid or reduce transfer taxes. Compare Estate of Murphy, T.C. Memo. 1990-472 (court applied substance over form doctrine and disregarded multiple transfers where the sole purpose of the transfers was to fragment a controlling interest in a corporation) with Estate of Frank v. Commissioner, T.C. Memo. 1995-132 (court declined to apply substance over form doctrine to disregard the form of transfers). Courts have also rejected attempts to avoid taxation of the control value of stock holding through fragmentation of a controlling interest. See Estate of Cidulka v. Commissioner, T.C. Memo. 1996-149 (donor's gifts of minority stock interests to shareholders followed by a redemption of donor's interest in the corporation treated as a single transfer of a controlling interest); Estate of Griffin v. United States, 42 F. Supp.2d 700 (W.D. Tex. 1998) (transfer of one-half of donor's stock to donor's spouse followed by a transfer of stock by spouse and donor to children treated as one gift by donor of the entire block). The application of the substance over form doctrine in any case is highly factual and depends upon whether there was substance to the transactions or whether the transactions were primarily to reduce or avoid federal transfer taxes. Further factual development is necessary to make this determination.

With respect to transfers of assets by Daughter, there is no indication that Daughter had authority, either as a trustee or by virtue of a power of attorney, to make such transfers. There is also no indication that any consideration was received for the transfers. An amendment to Trust names Daughter as a successor trustee, but only in the event of Decedent's "death, inability or unwillingness" to act as trustee. Should it ultimately be determined that Daughter held a power of attorney, the explicit authority contained in the power of attorney should be examined. In Estate of Swanson v. United States, No. 00-5079 (Fed.Cir. May 21, 2001), 2001 U. S. App. LEXIS 11537, decedent's attorney-in-fact made 38 separate gifts of decedents property shortly before decedent died. Although the power holder testified that the decedent agreed to the gifts, the power of attorney held no express authorization for making gifts. The court held that under California law, broad language in the power conferring authority to sell, exchange, transfer or convey property for the benefit of the principal does not authorize a conveyance as a gift. Accordingly, the gifts were not authorized under the power and the gifts were includible under § 2038 because the decedent retained the power to revoke the gifts.

Finally, any authorized transfers that constituted completed gifts should be subject to gift tax. If gifts were made during life, and a gift tax return was not filed, the statute of limitations on assessments should still be open. Further, in any event, any completed gifts would constitute adjusted taxable gifts under § 2001(b)(1)(B), and should be reflected in the estate tax computation.

CASE DEVELOPMENT, HAZARDS, AND OTHER CONSIDERATIONS

[redacted]

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Please call if you have any further questions.

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