Estate of Shelfer v. Commissioner, 102 T. C. 468 (1994)

For a trust to qualify as qualified terminable interest property (QTIP), the surviving spouse must be entitled to all the income from the property, including any income earned between the last distribution date and the date of the spouse's death.

Summary

In Estate of Shelfer v. Commissioner, the Tax Court ruled that the Share Number Two Trust did not qualify as QTIP because the surviving spouse, Lucille P. Shelfer, was not entitled to all the income from the trust, specifically the income earned between the last distribution date and her death. This income, termed "stub period" income, was instead payable to the remainder beneficiary upon the spouse's death. The court emphasized the statutory requirement that the surviving spouse must receive "all the income" from the trust during her lifetime. This decision impacts how trusts are structured to ensure they meet QTIP requirements, particularly regarding the distribution of income earned just before the death of the surviving spouse.

Facts

Lucille P. Shelfer's husband, Elbert B. Shelfer, Jr. , died in 1986, leaving a will that divided his estate into two trusts. The Share Number Two Trust provided income to Lucille during her lifetime, payable quarterly, but any income earned between the last distribution and her death was payable to her husband's niece. The executor of Elbert's estate elected to treat a portion of the Share Number Two Trust as QTIP, claiming a marital deduction. Upon Lucille's death in 1989, the IRS sought to include this portion in her estate, asserting it was QTIP. The estate contested this, arguing the trust did not meet QTIP requirements.

Procedural History

The executor of Elbert's estate filed a Form 706 in 1987, electing partial QTIP treatment for the Share Number Two Trust. Following an audit, the IRS accepted the election and issued a closing letter in 1989. After Lucille's death, her estate filed a Form 706 in 1989, excluding the trust from her gross estate. The IRS audited this return, and in 1992, issued a notice of deficiency, claiming the trust should be included as QTIP in Lucille's estate. The case was submitted to the Tax Court without trial, based on stipulated facts.

Issue(s)

1. Whether the Share Number Two Trust qualifies as QTIP under section 2056(b)(7) of the Internal Revenue Code, given that the surviving spouse was not entitled to income earned between the last distribution date and her death?

Holding

1. No, because the trust did not meet the statutory requirement that the surviving spouse be entitled to all the income from the property, including the “stub period” income, which instead passed to the remainder beneficiary upon her death.

Court’s Reasoning

The Tax Court focused on the statutory language of section 2056(b)(7)(B)(ii)(I), which requires that the surviving spouse be entitled to “all the income” from the property, payable at least annually. The court rejected the IRS’s argument that the proposed and final regulations allowed for the exclusion of “stub period” income, noting these regulations were not applicable to the case at hand. The court also distinguished its position from a Ninth Circuit ruling in Estate of Howard, asserting that the plain language of the statute required the surviving spouse to receive all income, including that earned between the last distribution and death. The court emphasized that an erroneous QTIP election cannot override the statutory requirements. The majority opinion, supported by several judges, reaffirmed the court’s prior holdings on this issue.

Practical Implications

This decision clarifies that for a trust to qualify as QTIP, it must ensure the surviving spouse receives all income, including that earned in the period just before their death. Trust drafters must carefully consider the distribution terms to comply with this requirement, as failure to do so may result in the loss of the marital deduction. This ruling also underscores the importance of understanding the applicable regulations and their effective dates, as newer regulations may not apply retroactively. Legal practitioners should advise clients on the necessity of clear trust provisions to avoid disputes with the IRS regarding QTIP status. Subsequent cases and legislative actions, such as the Tax Simplification and Technical Corrections Bill of 1993, have sought to address the “stub period” income issue, but this ruling remains significant for estates structured before those changes.