***103 T.C. 10 (1994)***

For a trust to qualify as Qualified Terminable Interest Property (QTIP), the surviving spouse must be entitled to all income from the property for life, including income accrued between the last distribution date and the date of death ('stub income'); if 'stub income' passes to someone other than the spouse or their estate, the trust fails QTIP requirements.

**Summary**

The Estate of Lucille Shelfer challenged a deficiency in federal estate tax. The core issue was whether a trust, for which a QTIP election had been made in the predeceased husband's estate, qualified as QTIP and was thus includable in the surviving spouse Lucille Shelfer's gross estate. The trust terms stipulated that income accumulated between the last distribution date and Lucille's death (stub income) would pass to the remainder beneficiary, not to Lucille or her estate. The Tax Court held that because Lucille was not entitled to all income, including stub income, the trust failed to meet QTIP requirements and was not includable in her estate. This decision reinforced the Tax Court's stance in *Estate of Howard*, despite Ninth Circuit reversal.

**Facts**

Elbert Shelfer, Jr. died, leaving a will that divided his residuary estate into two shares, held in separate trusts (Share Number One and Share Number Two Trusts). Lucille Shelfer, his surviving spouse, was to receive quarterly income from the Share Number Two Trust for life. The will stipulated that upon Lucille's death, the Share Number Two Trust would terminate, with principal and any undistributed income payable to Mr. Shelfer's niece. Importantly, Lucille had no power of appointment over the income accumulating between the last distribution and her death. Mr. Shelfer's estate elected to treat a portion of the Share Number Two Trust as QTIP and claimed a marital deduction. Lucille Shelfer died subsequently, and her estate did not include the QTIP portion of the trust in her gross estate.

**Procedural History**

1. **Elbert Shelfer, Jr.'s Estate Tax Return:** Filed Form 706, electing partial QTIP treatment for Share Number Two Trust and claiming a marital deduction. The IRS initially allowed the deduction. The statute of limitations expired for Mr. Shelfer's estate.

2. **Lucille Shelfer's Estate Tax Return:** Filed Form 706, excluding the QTIP trust property from her gross estate.

3. **IRS Audit of Lucille Shelfer's Estate:** IRS determined the Share Number Two Trust was QTIP and includable in Lucille's gross estate, issuing a notice of deficiency.

 

4. **Tax Court Petition:** Lucille Shelfer's estate petitioned the Tax Court to redetermine the deficiency.

**Issue(s)**

1. Whether the Share Number Two Trust qualified as Qualified Terminable Interest Property (QTIP) under I.R.C. § 2056(b)(7), such that it should be included in the gross estate of Lucille P. Shelfer under I.R.C. § 2044.

2. Specifically, whether the trust met the requirement that the surviving spouse be entitled to all income from the property for life, given that 'stub income' was not payable to her estate.

**Holding**

1. No. The Share Number Two Trust did not qualify as QTIP because Lucille Shelfer was not entitled to all the income from the property for life.

2. No. Because the 'stub income' accrued between the last distribution date and Lucille's death was to pass to the remainder beneficiary and not to Lucille or her estate, the requirement that she be entitled to 'all the income' was not met.

**Court's Reasoning**

The Tax Court reasoned that to qualify as QTIP, a trust must ensure the surviving spouse is entitled to "all the income" from the property for life. The court interpreted "all the income" to include income accrued but not yet distributed at the time of the surviving spouse's death (stub income). The court emphasized the plain language of I.R.C. § 2056(b)(7)(B)(ii)(I), stating, "The surviving spouse is entitled to all the income from the property, payable annually or at more frequent intervals."

The court rejected the Ninth Circuit's reversal in *Estate of Howard v. Commissioner*, which adopted a more lenient interpretation, focusing on the spouse being entitled to income "at the time of its annual or more frequent distribution." The Tax Court found this interpretation inconsistent with the statute's plain language requiring entitlement to "all the income." The court stated, "To the extent that the remainder beneficiary receives income earned on the corpus during the spouse's lifetime, as well as the corpus itself, the lifetime beneficiary has not received 'all the income'."

The court acknowledged proposed regulations suggesting that stub income not needing to be paid to the spouse or their estate wouldn't disqualify QTIP status, but noted these were not finalized or binding at the time and carried no more weight than arguments in a brief. The court also noted that while final regulations existed, they were not retroactive to the decedent's death date.

Dissenting opinions argued for a more practical, remedial interpretation of the QTIP statute, consistent with Congressional intent to treat spouses as a single economic unit and to broadly allow the marital deduction. Dissenters pointed to the purpose of QTIP to alleviate the dilemma of choosing between marital deduction and control over property's ultimate disposition. They also argued that the majority's interpretation led to an unjust result where a substantial trust corpus escaped estate tax entirely due to inconsistent positions taken by the estate and the expiration of the statute of limitations for the first spouse's estate.

**Practical Implications**

*Estate of Shelfer*, reaffirming the Tax Court's position in *Estate of Howard* (pre-reversal), highlights the strict interpretation of the "all the income" requirement for QTIP trusts, particularly concerning stub income. For estate planners, this case served as a cautionary tale: trust documents must explicitly ensure that stub income is payable to the surviving spouse's estate or subject to their general power of appointment to unequivocally qualify for QTIP treatment, at least within the Tax Court's jurisdiction outside the Ninth Circuit. While subsequent final regulations and legislative changes have addressed the stub income issue, *Shelfer* underscores the importance of precise drafting in estate planning to avoid unintended tax consequences and potential litigation, especially when relying on QTIP elections. It also illustrates the risk of inconsistent estate tax positions between spouses' estates and the potential for lost revenue when statutes of limitations expire on the first estate.