Estate of Dorothy M. Walsh, Deceased, Charles E. Walsh, Personal Representative v. Commissioner of Internal Revenue, 110 T. C. 393 (1998); 1998 U. S. Tax Ct. LEXIS 29; 110 T. C. No. 29

Incompetency provisions in a trust can disqualify property from the marital deduction if they prevent the surviving spouse from exercising a power of appointment in all events.

Summary

Charles and Dorothy Walsh established a trust to hold their property, with provisions for Trust A and Trust B upon the first spouse's death. Trust A was intended to qualify for the marital deduction, but included a clause that upon the surviving spouse's incompetency, the spouse would lose all benefits and control over the trust's assets. The estate claimed a marital deduction for the assets passing to Trust A, but the Tax Court held that the incompetency provisions disqualified the property from the deduction because they prevented the surviving spouse from exercising a power of appointment in all events, as required by IRC section 2056(b)(5).

Facts

Charles and Dorothy Walsh established the Dorchar Trust Agreement in 1992, transferring most of their assets to it. Upon the death of the first spouse, the trust's assets were to be split into Trust A and Trust B. Trust B was to be funded with $600,000, while Trust A would receive the remainder. The trust agreement specified that Trust A was intended to qualify for the marital deduction. However, it also included provisions that if the surviving spouse became incompetent, they would lose all benefits from Trust A and the trust's assets would be distributed to the couple's children. Dorothy died in 1993, and her estate claimed a marital deduction for the assets passing to Trust A.

Procedural History

The estate filed a petition in the U. S. Tax Court challenging the Commissioner's determination of a $291,651 deficiency in federal estate tax due to the disallowance of the marital deduction. The case was submitted to the court without trial. The Tax Court issued its opinion on June 15, 1998, holding that the property passing to Trust A did not qualify for the marital deduction.

Issue(s)

1. Whether the property passing to Trust A qualifies for the marital deduction under IRC section 2056(a).

Holding

1. No, because the incompetency provisions in the trust agreement prevent the surviving spouse from exercising a power of appointment in all events, as required by IRC section 2056(b)(5).

Court's Reasoning

The court applied IRC section 2056(b)(5), which requires that for property to qualify for the marital deduction, the surviving spouse must have a life estate in the income and a general power of appointment exercisable alone and in all events. The court cited Estate of Tingley v. Commissioner, where a similar provision terminating the surviving spouse's power upon legal incapacity disqualified the property from the marital deduction. The court rejected the estate's argument that the power of appointment in this case was activated by incompetency, finding that the critical issue was the possibility of the surviving spouse losing control over the trust assets due to a contingent event (incompetency). The court also noted that the trust's purpose included providing for the surviving spouse's subsistence during competency and facilitating medical assistance at minimal family expense upon incompetency.

Practical Implications

This decision underscores the importance of carefully drafting trust agreements to ensure compliance with the requirements for the marital deduction. Practitioners should avoid including provisions that could terminate a surviving spouse's power of appointment upon events like incompetency or remarriage. The ruling may impact estate planning strategies, particularly for clients concerned about preserving assets for future medical expenses while maximizing tax benefits. Subsequent cases, such as Estate of Meeske v. Commissioner, have reaffirmed the principle that a power of appointment must be exercisable in all events to qualify for the marital deduction.

