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In *Estate of Morgens*, the Tax Court ruled in favor of the government that section 2035(b) applied to gift taxes paid by qualified terminable interest property beneficiaries to gross up a widow's estate by that amount. The court held that section 2207A did not shift the gift tax liability to those beneficiaries to exempt the widow's estate from the application of section 2035(b).

After her husband's death on January 27, 2000,[1] Anne Morgens became the income beneficiary of a qualified terminable interest property (QTIP) trust, with the remainder at her death to benefit her husband's and her two sons and the children of their deceased daughter. Besides her income interest in the trust, Mrs. Morgens had a limited power of appointment,[2] which the court referred to as her ''principal invasion interest.'' Although Mrs. Morgens and the two sons were named as cotrustees of the QTIP trust, she resigned as a cotrustee on January 29, 2000. She then disclaimed her right to the principal invasion interest in the trust on September 22, 2000. Also on that date, one of the sons, Edwin, disclaimed his interest in the remainder and as a result, Mrs. Morgens acquired Edwin's disclaimed interest. On that same day, she partially disclaimed her newly acquired interest except for a special power to appoint any of her husband's issue and she appointed the interest to the other son and the two children of the deceased daughter.[3]

That November, Mrs. Morgens and the remainder beneficiaries of the QTIP trust signed an indemnification agreement whereby, in consideration of any gifts of her income interest in the trust, the remainder beneficiaries would indemnify her and her estate for specified gift and estate taxes. In December the cotrustees of the QTIP trusts petitioned the superior court to sever the QTIP trusts into two trusts, A and B, with Mrs. Morgens retaining her income interests in both.[4]

Also in December 2000, Mrs. Morgens transferred her income interests in Trust A proportionally to each remainder beneficiary. In so doing, she made a gift to them under section 2519. On her timely filed gift tax return, she calculated her net gift to be $4,111,592 (the gift of $6,398,901, minus $2,287,309, the gift tax liability paid by the donees). In January 2001, she transferred her income interests in Trust B proportionally to those remainder beneficiaries. After audit of these transfers, the agreed-on net gift value for Trust B was $13,937,756 (the gross amount of $21,623,964, less the donees' paid gift tax cost of $7,686,208).[5]

Mrs. Morgens died on August 25, 2002.[6] Her executor did not include in her estate the amount of the gift tax paid within three years of her death because he maintained that the gift tax was not paid by either her or her husband. The government argued that section 2207A(b) did not shift Mrs. Morgens's gift tax liabilities to the QTIP trustees and therefore, section 2035(b) applies. Her estate contended in court, however, that the government's interpretation would undermine the policy behind section 2207A and that because the QTIP trustees are ultimately liable for the gift taxes, section 2035(b) is not applicable.[7]

The court reviewed the applicable law, first explaining that the purpose of section 2035(b) is to prevent *inter vivos* transfers occurring within three years of decedent's death from evading the additional tax on transfers that are essentially testamentary. That is, because taxable gifts benefit from not having a transfer tax imposed on the amount used to pay the gift tax (unlike the estate tax which is a tax-inclusive tax, that is, the tax amount is itself subject to a tax), gifts that are made near a decedent's death should be taxed as they would be under the estate tax. Next, the court identified the novel issue in the case: the interconnection between section 2035(b) and the

[1] *Estate of Morgens*, 133 T.C. No. 17, at 3 (2009), *Doc 2009-28066*, *2009 TNT 244-19*.
[2] *Id*. at 5.
[3] *Id*. at 6-7.
[4] The trusts did not contain a spendthrift provision relating to Mrs. Morgens's income interest as did the original trust. Also, in terms of funding, Trust A contained ''115,000 shares of Proctor & Gamble common stock'' and Trust B had all of the remaining assets from the QTIP. ''Pursuant to Mrs. Morgens' exercise of the special power of appointment over Edwin Morgens' former interest and the terms of the residual trust pertaining to the remaining seven shares of the residual trust, the remainder beneficiaries of residual trust A were James Morgens, Anne Carpenter, and Matthew Bretz, and the remainder beneficiaries of residual trust B were James Morgens, Anne Carpenter, Matthew Bretz, and trusts for the benefit of Anne Carpenter and Matthew Bretz.'' *Id*. at 8.
[5] *Id*. at 9-11.
[6] *Id*. at 3.
[7] *Id*. at 16-17.

QTIP gift tax inclusion and liability provisions, sections 2519 and 2207A(b), the latter of which were enacted in 1981. The QTIP inclusion sections, section 2519 for gift taxes and section 2044 for estate taxes, require inclusion at the surviving spouse's termination of her income interest in return for marital deduction qualification and tax deferral at the first spouse's transfer. Without the QTIP provisions, the first spouse's transfer of a life estate to his spouse with the remainder to a third party would not have qualified for a marital deduction because the life estate would constitute nondeductible terminable interest.[8] That is, when the wife dies, her interest would not otherwise be an interest includable in her estate although the trust property would pass outside the marital unit. ''The purpose of the terminable interest rule is to deny the marital deduction for transfers between spouses if the transfer has been structured to avoid estate tax when the surviving spouse dies.''[9]

Because the surviving (or donee) spouse must be taxed on the underlying property over which she has no ownership rights, Congress enacted section 2207A to allow the second spouse to recover from the beneficiaries of the property the transfer taxes relating to her gift or estate inclusion. If the second spouse does not recover those taxes from the QTIP trust beneficiaries, she will be deemed to have made a taxable gift to them in that amount.[10]

The court described the artifice behind the QTIP marital deduction: ''Although Mrs. Morgens received no economic interest in the QTIP besides income for life, the QTIP regime employs a fiction that treats QTIP as passing entirely from the first spouse to die to the surviving spouse.''[11] The QTIP trust underlying property is not taxed until the surviving spouse either transfers her life estate during her lifetime or at her death. At that time, sections 2044 and 2519 continue ''the deemed transfer premise of section 2056(b)(7)'' and impute ownership to the surviving spouse. Because of this fiction, the court held that Mrs. Morgens was the deemed donor.[12]

While the court agreed with the estate that Congress intended QTIP trusts to bear the tax of the deemed transfer under section 2519, the court said that didn't mean Congress shifted the deemed donor's gift tax liability to them. The court explained that the private allocation of the tax burden is different from the statutory obligation for the gift tax, which under section 2501 is plainly on the donor and, under section 6324(b), only secondarily on the donee. Likewise, the court held that section 2207A(b) did not shift that primary responsibility for gift tax payment.[13]

Finally, the court stated that the legislative purpose of section 2035(b) was ''to eliminate the Code's incentives for deathbed transfers.''[14] A ''net gift'' describes a gift by which the donee's conditioned payment of the gift tax is the recipient's consideration. With a net gift, however, the donor has always intended to make a gift of the net amount. In the case of a net gift, in *Estate of Sachs v. Commissioner*,[15] the court held that the gift tax paid by the recipients was includable in the donor's estate when he died within three years of the gift because the purpose of section 2035 would otherwise be compromised. The estate had argued that Mrs. Morgens had not made a net gift, but the court disagreed and emphasized that a QTIP transfer makes the surviving spouse the deemed owner of the property. She had the primary responsibility for the gift tax payment; section 2207A(b) merely gave her a right of recovery.[16] The court distinguished *Brown v. United States*,[17] another case the estate had cited, because of the QTIP provision's imputation of ownership and dismissed the estate's argument that Congress in 1981 not only created the QTIP provisions but also implicitly amended section 2035(b).[18]

Estate of Mellinger v. Commissioner

In *Morgens*, the court cited *Estate of Mellinger v. Commissioner*[19] several times, referring to the court's comparative and contrasting treatment of the QTIP provisions in the two cases.[20] In *Mellinger*, the decedent's estate included stock that she owned outright in a revocable trust and in a QTIP trust established by her predeceased husband. The government argued that the decedent was the owner for valuation as well as inclusion purposes. Although the court held that the stock in the QTIP trust was included in her estate under section 2044, it held that the stock should not be aggregated with the other stock she owned at her death for valuation purposes. The court explained that section 2044 and its legislative history are silent on the issue of aggregation: ''This property is 'treated as property passing from the' surviving spouse, sec. 2044(c), and is taxed as part of the surviving spouse's estate at death, but QTIP property does not actually pass to or from the surviving spouse.''[21] Moreover, ''at no time did decedent possess, control, or have any power of disposition over the FOH shares in the QTIP trust.''[22] While section 2044 was enacted to ensure that the QTIP trust property would be taxed at least once, the court stated that section 2044 did not require ''identical tax consequences as an outright transfer to the

[8] *Id.* at 14. (''Section 2056(b)(7) allows a marital deduction for QTIP even though the surviving spouse receives only an income interest and has no control over the ultimate disposition of the property.'' *Id.*)

[9] *Id.*

[10] *Id.* at 16.

[11] *Id.* at 17.

[12] *Id.* at 18-19.

[13] *Id.* at 21-23.

[14] *Id.* at 23.

[15] 88 T.C. 769 (1987).

[16] *Morgens, supra* note 1, at 27-29.

[17] 329 F.3d 664 (9th Cir. 2003), *Doc 2003-11103*, *2003 TNT 85-8*. In *Brown*, the husband had given his wife funds to pay all of the gift tax on a gift she had consented to split with him. Applying the step transaction doctrine, the circuit court held that the gift tax was attributable to the husband and his wife was only a conduit. *Id.* at 29-30.

[18] *Id.* at 30-32.

[19] 112 T.C. 26 (1999), *Doc 1999-3887*, *1999 TNT 17-6*, *acq. at* 1999-2 C.B. xvi.

[20] *Morgens, supra* note 1, at 18, 19-20 n. 20, 31.

[21] *Mellinger, supra* note 19, at 35.

[22] *Id.* at 36.

surviving spouse.''[23] *Mellinger* relied on *Estate of Bonner v. Commissioner*,[24] which in turn had cited to *Estate of Bright v. United States*,[25] a case in which the Fifth Circuit refused to aggregate the decedent's fractional interests in real property in a QTIP trust with the same property he owned outright based on the rationale that section 2044 did not require the merger and the decedent never controlled the property in the QTIP trust.[26]

By contrast, in *Estate of Fontana v. Commissioner*,[27] the Tax Court held that, for valuation purposes, the shares decedent owned outright had to be combined with the stock held in trust over which he had a testamentary general power of appointment. Unlike *Mellinger*, in which the decedent's husband controlled the property in the QTIP trust, the court in *Fontana* held that a general power of appointment trust indicates the ownership equivalent necessary to have the shares aggregated with shares the decedent owned outright since, with a general power of appointment, the decedent (and not his spouse) controlled the ultimate beneficiary of the property.

Section 2207A

Section 2207A[28] was enacted in 1981 at the same time as the QTIP provisions. After several unsuccessful attempts[29] to ensure that the surviving spouse did not inadvertently waive the right of her estate to recover the taxes attributable to the QTIP, Congress amended section 2207A in 1997,[30] to alter the original language of section 2207A(a)(2)[31] to require a bright-line approach that indicates the surviving spouse's pointed intention to waive reimbursement from the QTIP trust beneficiaries.[32] To be clear that the surviving spouse indeed wanted to waive her right of recovery as to the transfer of property in the QTIP trust, the 1997 amendment to section 2207A requires a specific reference to the applicable code section — 2519 or 2044 —, QTIP or QTIP trust, to effectuate a waiver of that reimbursement right.[33]

Analysis and Conclusion

The QTIP provisions are seriously flawed and *Morgens* illustrates how the QTIP inevitably creates inequities. If it sounds confusing that the widow's estate has to pay taxes on property she never owned or controlled, that's because of the illogic behind the QTIP ''so-called marital'' deduction statute itself. Without the QTIP election, the property would have been a nondeductible terminable interest and taxed in her husband's estate and there would be no need to make the widow a fictional property owner. Here, it's the widow's status as surviving spouse that allows her predeceased husband to defer transfer taxes, and she is essentially a mere conduit to enable this statutory artifice.

It is the fiction of the QTIP provisions that makes the case so unsatisfying as well as at least somewhat inconsistent with *Mellinger*.[34] When the marital deduction is afforded to the first spouse to die even though his widow may not have had any input on the decision to make a QTIP election and needs only to receive an income interest in the trust property, it will always seem fundamentally unfair for the widow to be treated as if she owned the trust property itself. This arrangement can scarcely be described as ''marital'' and the deferral benefits inuring to third parties (that is, the family of the first spouse to die) are unsupported by the supposed rationale for the marital deduction.[35]

Morgens is correct. Under section 2035(b), the gift tax paid on transfers within three years of a decedent's death must be included in the surviving spouse's estate to augment the widow's estate tax liability. If she had retained her income interest until her death, the estate tax, a tax-inclusive tax, would have applied under section 2044. Of course, in that case, she would have had a section 2207A right of recovery from the QTIP trust for

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[23] *Id.* at 37.

[24] 84 F.3d 196 (5th Cir. 1996), *Doc 96-16744*, *96 TNT 111-13*.

[25] 658 F.2d 999 (5th Cir. 1981).

[26] *See Mellinger, supra* note 19, at 36-37.

[27] 118 T.C. 16 (2002), *Doc 2002-7744*, *2002 TNT 61-11*. The court in *Morgens* did not cite *Fontana*.

[28] P.L. 97-34, Title IV, section 403(d)(4)(A), 95 Stat. 304 (1981), amended by P.L. 105-34, Title XIII, section 1302(a), 111 Stat. 1039 (1997).

[29] *See, e.g.,* Tax Simplification and Technical Corrections Bill of 1993, H.R. 3419, 103d Cong., section 601 (1994); The Tax Simplification Act of 1993, H.R. 13, 103d Cong., section 701; the Revenue Act of 1992, H.R. 11, 102d Cong., sections 4701 and 4703; Tax Simplification Act of 1991, H.R. 2777, 102d Cong., section 501. ''Thus, a general provision specifying that all taxes be paid by the estate is no longer sufficient to waive the [surviving spouse's] right of recovery.'' Joint Committee on Taxation, 103d Cong., Technical Explanation of the Tax Simplification Act of 1993, 206 (Comm. Print. 1993).

[30] P.L. 105-34, Title XIII, section 1302(a), 111 Stat. 1039 (1997). In H.R. Rep. No. 105-148, 613-614 (1997), the description of present law stated:

> For estate and gift tax purposes, a marital deduction is allowed for qualified terminable interest property (QTIP). Such property generally is included in the surviving spouse's gross estate upon his or her death. The surviving spouse's estate is entitled to recover the portion of the estate tax attributable to inclusion of QTIP from the person receiving the property, unless the spouse directs otherwise by will (sec. 2207A). For this purpose, a will provision specifying that all taxes shall be paid by the estate is sufficient to waive the right of recovery.

[31] Section 2207A (a)(2), as enacted in 1981, read: ''Paragraph (1) shall not apply if the decedent otherwise directs by will.''

[32] Section 2207A (a)(2), as enacted in 1997, reads: ''Paragraph (1) shall not apply with respect to any property to the extent that the decedent in his will (or a revocable trust) specifically indicates an intent to waive any right of recovery under this subchapter with respect to such property.''

[33] H.R. Rep. No. 105-148, at 614.

[34] Regarding *Mellinger, supra* note 19, it is unclear why the court in that case allowed any departure from the fiction that the surviving spouse is the deemed owner of the QTIP trust property.

[35] *See* Wendy C. Gerzog, ''The Marital Deduction QTIP Provisions: Illogical and Degrading to Women,'' 5 *UCLA Women's Law J.* 301 (1995); Gerzog, ''Clack Estate: Adding Insult to Injury, or More Problems With the QTIP Tax Provisions,'' 6 *So. Cal. Rev. Law and Women's Studies* 221 (1996); Gerzog, ''The Illogical and Sexist QTIP Provisions: I Just Can't Say It Ain't So,'' 76 *N. Car. L. Rev.* 1597 (1998); Gerzog, ''Solutions to the Sexist QTIP Provisions,'' 35 (ABA) *Real Prop., Prob., & Tr. J.* 97 (2000).

that amount. Unfortunately, however, she does not have a corresponding right of recovery under section 2207A for this estate tax increase, even though the tax relates to the QTIP trust. It is unclear from the case whether the indemnification agreement would apply to estate taxes imposed by section 2035(b),[36] but if not, there does not appear to be a section 2207A recovery right from the QTIP beneficiaries regarding those additional estate taxes.

It appears that Congress did not anticipate the unfair tax burden placed on the surviving spouse's estate when there is no voluntary indemnification agreement regarding additional estate taxes caused by the proper application of section 2035(b). That is, although the widow's estate must include the gift taxes paid in connection with her QTIP transfers made within three years of her death, she does not have a recovery right under section 2207A for those additional estate taxes. The tax recovery statute specifically references only the imposition of gift tax or estate tax under sections 2519 and 2044. Thus, there needs to be a legislative solution to address the extra burden on the surviving spouse when the widow makes gifts of her QTIP interest within three years of her death. Congress should amend section 2207A to apply also to the additional estate taxes caused by the inclusion of the gift taxes paid under section 2035(b). (Or, even better, Congress needs to repeal the QTIP provisions themselves!)

[36]*See Morgens*, *supra* note 1, at 7.