

# The 5-Minute Trust and Estate Update

October 2007 from James M. Kane, Attorney

This periodic e-mail update provides readers with a short "coffee break" summary of certain ideas and developments that affect a broad range of clients. The topic in this issue addresses the substantial financial cost to a family for failure to use the full estate exemptions of each spouse and how an inter-vivos QTIP trust is an excellent remedy.

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## Why Donate an Extra Million to the IRS?

There are far too many situations where married couples effectively donate to the IRS up to \$1.0 million or more in unnecessary estate tax. This is simply due to failure to use each spouse's \$2.0 million estate exemption.

This update highlights two excellent benefits of a lifetime QTIP trust that a spouse can put into place while alive (thus, an "inter-vivos" QTIP trust). The term "QTIP" under the tax law stands for "qualified terminable interest property".

First, the inter-vivos QTIP trust helps enable each spouse to use his and her own \$2.0 million estate exemptions, in some situations producing an overall \$1.0 million savings in estate tax.

In contrast to making an outright transfer of property to the other spouse, the inter-vivos QTIP trust allows the propertied spouse to transfer \$2.0 million in trust for the other spouse, but still maintain control over the property both as trustee and with a limited power of appointment over the trust income and corpus. The propertied spouse can also be a contingent beneficiary of the QTIP

trust, in the event he or she survives the other spouse. This QTIP trust (compared to an outright transfer) is an appealing planning option for spouses in second marriages, particularly with children from different marriages, and so forth.

Second, there are income tax / indirect gift benefits with the inter-vivos QTIP trust. The trust can be designed as a "grantor-trust for income tax purposes" for the entire lifetime of the spouse who creates and funds the trust. With this grantor-trust status, that spouse pays the income tax on the trust's income instead of the trust using its own assets to pay the tax. This preserves the value of the trust property. The payment of the income tax by the spouse effectively becomes a non-taxable gift to the spouse's children and grandchildren as remainder beneficiaries of the QTIP trust.

Both of the above benefits are available if the inter-vivos QTIP trust is put into place while the spouses are alive. Similar results are not available if the QTIP trust is otherwise created at death (a "testamentary" QTIP trust).

Those who can best use the inter-vivos QTIP are: (i) married couples where one spouse does not own enough property in his or her own right equal to the full \$2.0 million estate

exemption and (ii) any spouse who wishes to preserve more fully the value and future appreciation of his or her \$2.0 million estate exempt property.

Here is more information about each of these two benefits for this inter-vivos QTIP trust.

### ***The First-to-Die Spouse's \$2.0 Million Estate Exemption –***

The concept of making sure each spouse can use his and her respective \$2.0 million estate exemptions is not rocket science. It is, however, the stark simplicity of this concept that causes many married couples to let it slip away. The simplicity produces less-than-urgent attention to this subject. Many couples also are typically not aware of the dimensions of the estate-tax cost if a spouse dies with property less than the \$2.0 million estate exemption.

The financial cost can be \$1.0 million or more of otherwise unnecessary estate tax payable to the IRS and state coffers rather than to the family. This is based on the current estate tax rate of 45 percent, plus in some states an additional state death tax.

So, why do married couples let \$1.0 million slip away from their families by exposing themselves to this otherwise avoidable estate tax?

It is most frequently the understandable reluctance by the propertied spouse to give \$2.0 million (or more) to the other spouse, with the corresponding loss of control over the transferred property. This is not an unreasonable stance and is typical with second marriages, particularly with children from each previous marriage (and sometimes children from the current marriage).

The inter-vivos QTIP can cure this reluctance. It enables the spouse with the greater amount of property to transfer \$2.0 million or

more of property into the trust for the other spouse, with the propertied spouse being able to maintain continuing control over the trust property as trustee.

This effectively doubles the propertied spouse's estate exemption to \$4.0 million, by using the non-propertied spouse's \$2.0 million estate tax exemption to tag the QTIP trust property as exempt from estate tax.

The written terms of the QTIP trust can, if desired, limit the recipient spouse's benefit only to the trust income, with no corpus distributions (trust income consisting essentially of interest and dividends, but not capital gains). The written trust terms also mandate what happens to the remaining QTIP trust property after both spouses' deaths. In most cases, the QTIP trust ultimately will continue in further trust for the descendants of the propertied spouse who initially created and funded the trust.

Finally, the written provisions of the inter-vivos QTIP trust give the propertied spouse both (i) a limited power of appointment to direct any part of the trust income and corpus to other family members and (ii) a position as a contingent beneficiary of the QTIP trust, but only if the propertied spouse survives the death of the non-propertied spouse.

### ***The Benefit of the "Grantor-Trust for Income Tax Purposes" Status –***

This is a complex, and technical, income tax feature of the inter-vivos QTIP trust that is most likely conversation fodder only for tax lawyers and CPAs. It is not a concept that many couples are aware of or think about in the context of their estate planning (nor should they be expected to unless someone points it out to them).

This benefit deals with a basic concept in estate and gift planning. That is, property exempt from estate, gift or GST tax ideally should be held in a manner that best

preserves the value of the exempt property. This "grantor-trust for income tax purposes" method is to avoid having the property value diminished each year by the income tax on the property, thereby allowing more of it to continue growing estate-tax free.

This grantor-trust concept applies to a person's \$2.0 million estate exemption. With ideal planning in place, the continuing appreciation in value of this exempt property will ultimately be available as a long-term growth asset for a couple's children and grandchildren. Its value can be better preserved without reduction for yearly income taxes on the exempt property.

The goal of preserving this exempt property can be enhanced with the inter-vivos QTIP trust. The trust can be specifically designed so that the propertied spouse who creates and funds the trust continues to pay the income tax on behalf of the QTIP trust by spending-down other available assets that are not exempt from estate tax.

This payment of the QTIP trust income tax using other non-trust sources will continue as long as the propertied spouse is alive, regardless of whether the propertied spouse dies before or after the other spouse.

The spouse's payment of the QTIP trust's income tax each year will ultimately benefit the children and grandchildren by not decreasing the value of the remaining trust property they ultimately receive from the QTIP trust. This is a substantial financial benefit to the children and grandchildren, because the spouse's payment of the income tax is effectively an indirect non-taxable gift to them for gift tax purposes.

#### ***Other Points to Consider for the Inter-Vivos QTIP Trust –***

Here are some points to consider in whether the inter-vivos might be useful for a broader range of married couples.

***Deathbed Transfers Using this QTIP Trust –***  
This inter-vivos QTIP trust can be used as a stand-by mechanism in situations where the spouses are older and death appears more imminent for the non-propertied spouse. The trust can be already in place with a nominal funding for its creation (e.g., "\$10 and other valuable consideration"). The propertied spouse can thereafter fund the QTIP trust as a deathbed transfer if necessary to assure the other spouse will have sufficient property to use the full estate exemption.

Being in a stand-by position for this type of deathbed transfer is an excellent planning option with the current \$2.0 million estate exemption and will be particularly beneficial during 2009 when the estate exemption increases to \$3.5 million.

***Future Changes in the Estate Exemption –***  
The written provisions of the inter-vivos QTIP trust include formula language that adjusts for any future changes in the estate exemption amount.

In view of the slated increase of the exemption to \$3.5 million in 2009, some married couples are making sure presently that each of them will be deemed to own at least \$3.5 million of property in 2009 in the event death were to occur that year. The above inter-vivos QTIP trust will, therefore, ideally need to be funded now with \$2.0 million and in 2009 up to \$3.5 million.

On the other hand, some spouses are concerned about over-funding the inter-vivos QTIP trust due to possible changes (a reduction?) in the estate exemption. This concern can be remedied by having the written terms of the trust require that any excess QTIP trust property not needed to bring the non-propertied spouse's estate up to the maximum available estate exemption (at that spouse's death) be distributed outright from the QTIP trust back to the propertied spouse.

Thus, this QTIP trust effectively uses only

whatever portion of the trust property is necessary for the non-propertyed spouse to use the full estate exemption, if that spouse predeceases the propertyed spouse.

*If Both Spouses Already Have Sufficient Property for Their \$2.0 Million Estate Exemptions* – This inter-vivos QTIP technique is even beneficial if both spouses already have enough of their own property for their \$2.0 million estate exemptions. The primary use of the QTIP trust in this case is to obtain the grantor-trust income tax feature.

Clients with larger estates are certainly not excluded as candidates for making sure the exempt estate property can grow undiminished each year by income tax. These clients also generally have ample other financial resources available to them to pay this income tax. The benefit of the indirect gift to the children and grandchildren as remainder beneficiaries of the QTIP trust is excellent tax planning for these wealthier clients.

In the case of these wealthier families, the spouse who is not expected to die first can create and fund an inter-vivos QTIP trust. The primary benefit here will be the income tax and indirect gift benefits of the grantor-trust status for the QTIP trust.

Whether or not they are in the wealthy category, spouses also can each create separate inter-vivos QTIP trusts for the other, as long as the planning contemplates and avoids the reciprocal trust doctrine.

*Divorce* – Some spouses, especially the propertyed spouse, are concerned about how a future divorce could affect this inter-vivos QTIP trust. In this situation, the QTIP trust can include a provision that gives both spouses the joint power to terminate the trust and divide the trust property as provided under a final judgment of property division upon dissolution of the marriage.

The key technical consideration is that this power must be subject to the condition that it can only be exercised if there is a final judgment of property division upon divorce. The power, if not already exercised, must also become null and void, and lapse entirely, at the earlier of either spouse's death, or upon a release of the propertyed spouse's limited power of appointment (already discussed above).

*Subchapter S Stock* – The spouse who funds the trust, and who also holds the limited power of appointment, will be treated as owner of the income and corpus of the trust for income tax purposes. This will allow the trust to hold S corporation stock. The death of either spouse, or a release of the limited power of appointment, will require a reexamination of the S corporation status of the trust. For those readers wishing to delve into more details on this point, see Treas. Reg. Section 1.1361-1(h)(1)(i).

Please contact us if you would like to discuss this e-mail update as it may relate to your particular situation or if you have any other legal or tax needs. This e-mail update should not be construed as legal or tax advice nor as an opinion in support of a reader's particular situation.

James M. Kane, Attorney  
Member of the Georgia, North Carolina and  
New York Bars

Chamberlain, Hrdlicka, White,  
Williams & Martin  
191 Peachtree Street, N.E.  
Thirty-Fourth Floor  
Atlanta, Georgia 30303-1747  
(404) 658-5422 (direct)  
(404) 658-5522 (direct fax)  
(404) 659-1410 (receptionist)

[james.kane@chamberlainlaw.com](mailto:james.kane@chamberlainlaw.com)