



For Married Couples Who Can't Commit (a *revocable inter-vivos QTIP trust*)

September 2008 from James M. Kane, Attorney

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This newsletter is about using a revocable inter-vivos QTIP trust for potentially saving \$900,000 or more of estate tax, analogous to an investment opportunity of 45 cents on the dollar.

The term "QTIP" under the tax law stands for "qualified terminable interest trust". [It is pronounced just like the cotton swab. For readers who are not familiar with QTIPs, I will be glad to send you a short summary of additional QTIP trust information at your request.] The term "inter-vivos" is for a trust a person creates during lifetime.

As to the potential \$900,000 tax savings, it is based on the current federal 45% estate tax rate coupled with one spouse's failure to use the \$2.0 million estate exemption. This can translate into a permanent loss of \$900,000 or more for families [45% times \$2.0 million].

The loss can be greater if the estate also is subject to state death tax, and, of course, even higher if the federal estate exemption is more than \$2.0 million (as is scheduled to happen next year).

The cause of this \$900,000 loss is typically for the following two reasons: (i) one spouse owns the bulk of the assets with the other spouse owning less than the estate exemption amount, or (ii) the bulk of the first-to-die spouse's property is JWROS (jointly owned with a right of survivorship)

that passes to the surviving spouse as marital deduction property leaving the first-to-die spouse's estate with no property to apply against the unified credit. Either one of these situations can create a \$900,000 permanent loss, or more.

The identification of the problem is fairly simple. However, what is not always so simple is whether one spouse should transfer assets to the poorer spouse merely to give that spouse enough property to use his unified credit. A transfer of assets between spouses can be a test of financial commitment that many couples prefer to wait and think about – and act on – at some later date. Unfortunately, in many cases the "later date" never arrives.

The good news, however, is that this \$900,000 issue can be addressed now in order to protect against the poorer spouse losing use of the estate exemption, without a full commitment by the funding spouse.

The remedy is for the spouse with the greater amount of assets to fund an inter-vivos QTIP trust and thereafter retain over the QTIP trust property either a power to revoke the trust, or a general or limited power of appointment, or both powers. The funding spouse also can be the trustee.

The unique element of this inter-vivos QTIP planning is that the funding spouse retains

continuing control over the trust assets. Therefore, this is a very effective and powerful estate plan with a high level of flexibility – and no full commitment.

A power to revoke the trust, or a general or limited power of appointment, leaves the door open for the funding spouse to redirect, if necessary in the future, a portion or all the trust property to others (such as children), or back to herself.

Whether the funding spouse retains a power to revoke or a power of appointment, or both, can be addressed in each client's situation. The retention of only a limited power of appointment may in some instances provide the funding spouse with greater level of asset protection for the QTIP trust assets.

Also, in some situations this inter-vivos QTIP can be used as a spouse's core estate planning document into which other assets not already in the trust at death can be added with a pour-over Will.

This inter-vivos QTIP trust funded by the spouse with the greater amount of assets, accomplishes several things. It:

- (1) assures that each spouse uses his or her entire estate exemption (currently, \$2.0 million);
- (2) effectively gives the funding spouse with the greater assets a double estate tax exemption, by tagging the QTIP trust assets with the poorer spouse's otherwise unused estate exemption. Thus, the spouse with the greater assets (using this year's \$2.0 million estate exemption) can protect \$4.0 million from estate tax;
- (3) may potentially result in a stepped-up basis for a portion or all of the QTIP trust assets (for income tax purposes) upon the death of the poorer spouse; and

- (4) does not require a separate trust income tax return during the funding spouse's lifetime.

Keep in mind the primary benefit I discuss here centers on items (1) and (2) for avoiding the loss of the poorer spouse's otherwise unused \$2.0 million estate exemption. The item (3) stepped-up basis for the QTIP trust assets for income tax purposes, if the poorer spouse dies first, is a potential opportunity and any related income tax savings will be in addition to the \$900,000 estate tax savings.

I do not address further in this newsletter the income tax potential of getting the stepped-up basis if the poorer spouse predeceases the funding spouse.

The target groups who can best benefit from this inter-vivos QTIP trust are:

- (1) married couples (particularly second marriages), where the poorer spouse owns less than \$2.0 million in assets; and
- (2) wealthier clients, where each spouse already owns enough property for full use of the estate exemption. The primary benefit here of using an inter-vivos QTIP trust is an income tax benefit that better preserves the value of a credit-shelter trust by the trust not having to use trust funds for paying its income tax.

This income tax payment feature of the QTIP trust for wealthier clients also is in line with the Supercharged Credit Shelter Trustsm, by New York attorneys Jonathan Blattmachr and Mitchell Gans, both of whom articulate very well the significant benefits of an inter-vivos QTIP trust.

The rest of this newsletter, however, addresses only the above target group (1) and does not include further details about this income tax payment feature for a QTIP

trust. I will be glad to discuss this payment feature further at your request.

The Key Gift Tax Planning Feature of this Inter-Vivos QTIP Trust

For gift tax purposes, the funding spouse's transfer of assets to the QTIP trust is an incomplete gift due to her retention of a power to revoke or power of appointment (or both).

However, the key feature of this QTIP trust planning is that the funding of the QTIP trust later becomes a completed gift by the funding spouse at the time of the poorer spouse's death, if the poorer spouse predeceases the funding spouse.

Upon the poorer spouse's death, correspondingly, the value of the QTIP trust assets will be included in the poorer spouse's estate, thus available to apply against the poorer spouse's \$2.0 million estate exemption.

The terms of the QTIP trust will thereafter include the funding spouse as a beneficiary, along with her children (depending on the particular design of the trust provisions).

What Ultimately Triggers the QTIP Marital Deduction Gift?

The written terms of this QTIP trust provide that the funding spouse's retained powers (power to revoke or power of appointment, or both) terminate upon the earlier of: (i) the funding spouse's death, (ii) the poorer spouse's death, or (iii) a renunciation in writing by the funding spouse of these retained powers.

The termination of these otherwise retained powers completes the gift, thus triggering a QTIP marital deduction gift from the funding spouse to the QTIP trust. For most clients, this termination will occur only upon the first-to-die spouse's death.

Although there typically will not be a need to trigger a QTIP marital gift during the funding spouse's lifetime, there are some generation-skipping tax ("GST") planning benefits that may in some cases warrant immediate QTIP gift treatment. I do not discuss these GST situations in this newsletter.

Key Income and Estate Tax Aspects

For income tax purposes, the inter-vivos QTIP trust is an intentionally defective grantor trust as to the funding spouse for her lifetime. It will use the funding spouse's SSN. No separate trust tax return will be required for the trust during that spouse's lifetime.

This grantor trust status results for two reasons: (1) the funding spouse's retained powers (either or both the power to revoke and power of appointment) trigger Code Section 674(a); and (2) the poorer spouse's income interest in the QTIP trust triggers Code Section 677.

For estate tax purposes, the result depends on which spouse dies first.

- If the poorer spouse dies first, his death will terminate the funding spouse's retained powers, thus resulting in a completed marital deduction gift from the funding spouse to the QTIP trust (see item (ii) of the above three triggering points). The value of the QTIP trust assets will be includible in the poorer spouse's estate under Code Section 2044, with potentially a stepped-up income tax basis for some portion or all of the assets.

The poorer spouse's estate may then make its own partial QTIP election for the portion of the QTIP trust that exceeds the poorer spouse's unified credit. No QTIP marital deduction will be claimed for the unified credit portion of the QTIP trust.

The QTIP trust at this point (where the poorer spouse predeceases the funding spouse) will divide into two subtrusts and continue as a QTIP marital subtrust for the funding spouse (who is the surviving spouse) and a credit shelter subtrust for the funding spouse and her children.

After both spouse's deaths, the QTIP trust will be divided into separate trust shares for the funding spouse's children.

- If the funding spouse dies first, the value of the QTIP trust property is includible in her estate for estate tax purposes as a result of the funding spouse's retained powers. These powers also terminate the death of the funding spouse.

At that time all of the assets in the QTIP trust will get a stepped-up basis due to this inclusion of the assets in the funding spouse's gross estate.

The trust assets will then be divided into a QTIP marital subtrust for the benefit of the poorer spouse and a credit shelter subtrust that can include the poorer spouse and the funding spouse's children, using a QTIP election as to all, part of, or none of the property in the trust.

The estate also can allocate the funding spouse's GST exemption, as necessary, to any non-elected QTIP

portion of the trust (the credit shelter portion) and by making a reverse QTIP election.

Upon the poorer spouse's subsequent death, the QTIP marital subtrust will be includible in his estate under Code Section 2044 for estate tax purposes, offset by his own unified credit, and with a stepped up basis at the time of death for these marital trust assets. The credit shelter subtrust will not be included in the poorer spouse's estate for estate tax purposes.

- For readers who desire a greater level of technical discussion, IRS Private Letter Ruling 200413011 (12/3/2003) is an excellent start and gives a good summary of various technical points for an inter-vivos QTIP trust.

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