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*A newsletter for attorneys, accountants, and other professionals engaged in financial and estate planning.*

## QTIP Approaches: Good, Bad, and Ugly

The QTIP (qualified terminable interest property) trust is a familiar and reliable tool that has become a staple in the estate plans of many married couples. As with any basic tool, new QTIP variations have arisen to meet various circumstances. Some of these variations have been more successful than others. In some cases, modifications of QTIP arrangements have backfired and defeated the benefits of standard, unadorned, QTIP arrangements that would otherwise have been effective.

### The Good . . . An A/B Plan

The focal point of the modern marital estate plan is a two-trust combination. One trust (the credit shelter trust) takes advantage of the decedent spouse's unified credit, while the other trust qualifies for the federal estate-tax marital deduction.

While an outright gift to the surviving spouse would qualify for the marital deduction, the Economic Recovery Tax Act of 1981 (ERTA '81) also made it possible to provide a spouse with a terminable interest, i.e., an income interest for life, which qualifies for the marital deduction if requirements are met. Under Internal Revenue Code Section 2056(b)(7), all income from QTIP must be paid to the surviving spouse at least annually and no one may appoint any portion of the trust property to any person other than the surviving spouse.

Like most modern documents, a QTIP trust can be reproduced from a form book, generated on a word processor, or constructed with computer assistance using interactive software. Without any argu-

ment, all of these methods get the job done as far as establishing the standard, highly effective QTIP-plus-credit-shelter arrangement, a.k.a. the two-trust, or A/B approach, that is widely followed.

What makes a basic, "no-frills" QTIP trust valuable in the first place? Several advantages come to mind. First, a QTIP trust can reduce taxes. Second, a QTIP trust can retain flexibility by allowing invasions of principal for selected purposes. And third, a QTIP trust accomplishes a useful distribution of assets — providing the surviving spouse an income interest with the remainder to others, yet qualifying the transfer for the marital deduction.

When the advantages of a two-trust plan are listed on paper, many of them actually relate to the fundamental attributes of a professionally administered trust — investment supervision, impartial administration, asset protection from creditors, etc.

### Strategies Beyond Credit Shelters

Moreover, there's more to estate-tax planning than the credit shelter trust. Certainly, the unified credit enjoys special status because it is a limited resource and, if you don't use it, you lose it. The unified credit currently protects up to \$650,000 of an estate from gift or estate tax, and that amount will increase to \$675,000 in 2000. However, the unified credit is certainly not the only advantage that should be exploited by each spouse's separate estate.

**The GST Exemption.**— Each spouse also has a \$1 million exemption from the generation-skipping transfer (GST) tax (actually \$1,010,000 due to cost of living adjustments). Suppose an estate plan utilizes a formula for funding trusts. For example, in

1999, an estate might fund a credit shelter/GST trust with \$650,000, based on the available unified credit. If the remainder of the estate passes to the QTIP trust, there will be \$360,000 of unused GST exemption. To take advantage of this amount, the estate would have to make a "reverse QTIP election" under IRC Sec. 2652(a)(3) for GST purposes.

The election allows the decedent spouse to continue to be treated as the property's transferor for purposes of using the GST exemption, even though the trust assets will be included in the surviving spouse's estate. However, since this election must be made to an undivided QTIP trust, it is necessary to establish two separate QTIP trusts, one of which can then be used in conjunction with the reverse QTIP election. A provision enabling the trustee to sever a QTIP trust may therefore be useful in making a reverse QTIP election possible. The Internal Revenue Service recently ruled that estate-tax liability should be apportioned between a QTIP trust for which the reverse election was made and a QTIP trust that was not exempt from GST tax consequences (Private Letter Ruling 199927007).

### The Bad . . . Flawed QTIP Plans

Although the basic QTIP/credit shelter trust arrangement is widely used, a steady stream of cases reveals what can go wrong when the arrangement is modified in an attempt to give the surviving spouse additional powers or discretion. It is therefore instructive to take note of approaches that may run into trouble.

**Restrictions.**— A requirement that the QTIP trust sell closely held stock for a particular price that could be less than the fair market value essentially takes value away from the surviving spouse's interest. As a result, no QTIP marital deduction was permitted in *Estate of Rinaldi* (38 Fed. Cl. 341). The U.S. Supreme Court recently declined to review this case.

**Appointment Power.**— A spouse can have the power to appoint the principal of the credit shelter trust to the children/remaindermen with certain limitations. But appointment of assets to children the spouse is legally obligated to support may constitute a taxable gift. A gift may also result to the extent that the spouse's present income interest in the trust is reduced by the transfer.

**Invasion Power.**— The spouse's ability to invade the corpus of the credit shelter trust can be limited by the discretion of the trustee. If the spouse is serving as trustee or co-trustee and has

unbridled power to invade the principal, the power is not limited by an ascertainable standard and the spouse will have a general power in the asset for tax purposes (IRC Secs. 2041 and 2514). In several jurisdictions, state laws also prohibit a trustee from using a power of appointment to benefit himself or herself.

Invasion powers can also be limited by giving the spouse a general power that is limited to \$5,000 or 5% of the trust. Such a power will not result in a gift if the power lapses (IRC Sec. 2041(b)(2)). Note also that the sequence of invasion should also be considered. It makes sense to have the surviving spouse invade and exhaust the QTIP assets first because they, unlike the credit shelter assets, will be included in the spouse's gross estate.

**Trustee Power.**— As trustee, a surviving spouse would certainly have more "hands-on" control over the assets, but a number of caveats are in order. For example, with too much power, the spouse will have a general power for tax purposes. In addition, family conflicts may arise.

### QTIP Variations

As with the credit shelter trust, the surviving spouse may be granted various powers over the QTIP trust. Will income from the trust be sufficient? An invasion power can be carefully drafted to allow trust principal to be used for a spouse's "health, support, education, and maintenance." Those who stray from the specific language of IRC Sec. 2041 with subjective terms like "comfort" or "happiness" invite trouble.

**Choice of Fiduciaries.**— An impartial fiduciary is particularly relevant in a second-marriage situation where the trust beneficiaries are children of a previous marriage. In that circumstance, the spouse serving as sole trustee may have a conflict of interest. And, as a general rule, trusts don't get involved in litigation because a corporate fiduciary was too impartial — it is frequently just the mere perception of a family member's bias, inexperience, or failure to communicate that brings people to court.

**Other Powers.**— While it may not always be suitable to name the surviving spouse as the trustee, it is possible to give the spouse power to change the trustee. However, this can constitute a general power of appointment over trust assets if the trust language is drafted too broadly.



## The Ugly . . . Experimental QTIPs

Creative minds are always pushing the envelope of QTIP science. Some of these ideas have been debunked. The surviving spouse's purchase of the QTIP's remainder interest is a case in point.

*Matter of Olsten* (reported in the *New York Law Journal*, July 8, 1993, p. 28) was a probate court case that involved a QTIP trust originally worth \$53 million. When the trust was worth \$75 million, it was proposed that the surviving spouse purchase the remainder interest of the QTIP trust using a promissory note. Once the spouse got the QTIP assets, she could sell them to satisfy the note. In the process, the remainder interest, which would have been taxed in the surviving spouse's estate, would, in theory, be removed from the estate without incurring transfer tax. As hopeful as this was, a fair amount of skepticism is warranted whenever tax alchemists propose turning a taxable interest worth \$50 million (in this case, 66.6% of the trust's present value) into a paid debt that escapes taxation.

Last year, the remainder-purchase approach was repudiated by Revenue Ruling 98-8 (IRB 1998-6), in which the IRS confirmed that such a maneuver results in a disposal of assets — a taxable transfer under IRC Sec. 2519.

## Flexibility, Clayton Style

Insofar as many other adaptable QTIP trust variations exist, it behooves the practitioner to steer clear of known pitfalls and experimental approaches. On the other hand, it is readily apparent that the use of various spousal powers can add flexibility to trusts as they are implemented. On a macro level, the overall alignment of different trusts may also need to be adjusted and coordinated within a given estate as circumstances change.

**Partial QTIP Election.**— For example, an executor or personal representative can make a partial QTIP election to adjust the portion of the estate that will qualify for the marital deduction. However, the assets allocated to the trust remain in place as anticipated and are subject to the same trust terms.

**Disclaimer.**— A surviving spouse can also disclaim QTIP assets. However, the disclaimer would have to be timely and meet all requirements. Another potential problem is the prerequisite that the surviving spouse remain willing to execute the disclaimer.

**Clayton Arrives.**— A powerful new tool, named for the case of *Estate of Clayton v. Commissioner* (976 F.2d 1486 (1992)), allows the executor or personal representative to participate earlier in the process by exercising discretion in regard to the extent to which the QTIP trust is funded. It has taken a long line of cases fought in three different appellate circuits to convince the IRS to concede the issue.

It is now possible for a bequest to qualify for the marital deduction, even if the executor is given the discretion to fund the QTIP trust — or not. This has the same impact as a disclaimer, but does not rely on the surviving spouse. (See *Estate of Robertson v. Comm'r*, 15 F.3d 779 (1994); *Estate of Spencer v. Comm'r*, 43 F.3d 226 (1995); *Estate of Clack*, 106 TC 131 (1996).)

## Putting It All Together

There are so many strategies, yet an estate has only so many assets to go around. Coordination is needed. This brings us back to the marital team. While it's nice to plan for the use of various tax benefits in each spouse's estate, an obvious prerequisite is that each spouse must have sufficient assets to take advantage of these techniques. In this regard, we must fight the influence of stereotypes. The husband may not die first. An older, infirm spouse may survive a younger, healthy spouse.

**QTIP Trust and Charitable Remainder.**— A QTIP trust can be structured with a charitable remainder to eliminate estate tax in the estates of both spouses. The first estate won't qualify for the estate-tax charitable deduction for the charitable remainder interest, but the entire trust will qualify for the marital deduction. Although the trust is then included in the surviving spouse's estate, it will qualify for a charitable deduction.

**Retirement Assets.**— The surviving spouse may already have an interest in the decedent's retirement plan. If retirement assets are used to fund QTIPs, the first step is an examination of the plan or IRA to see what payment options are permitted. The ensuing trust will have to meet QTIP requirements as well as the tax law's minimum distribution requirements.

**Marital Deduction Formulas.**— In funding QTIPs, the marital deduction formula will depend on whether any estate tax is to be paid when the first spouse dies, whether a fractional share or a

pecuniary formula is used, and which assets are available in light of the overall estate plan.

Although QTIPs were legislatively approved a mere 18 years ago, they have become a fundamental estate-planning building block for every married couple with a potentially taxable estate. Which QTIP approach is the best? There are many excellent provisions to empower the surviving spouse or other heirs and guide asset management in the future. On the other hand, the longer and more involved any document, the more time needed to interpret it. There's a lot to be said for keeping things simple.

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## Recent Developments

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### Trust Interests Not Aggregated

Husband left fractional interests of real estate to Wife in two trusts. Although Wife owned an undivided interest in the real estate, interests held in a survivor's trust did not have to be aggregated with interests held in a QTIP marital trust. Following the Fifth Circuit's decision in *Estate of Bonner* (84 F.3d 196) and the Tax Court's decision in *Estate of Mellinger v. Comm'r* (112 TC No. 4, 1/26/99, reported in the May issue of *R&D*), the Tax Court concluded that IRC Sec. 2044 does not require property passing through a decedent's estate in a QTIP trust to be treated as if it were actually owned by the decedent for purposes of aggregation. For valuation purposes, those property interests do not have to be merged or aggregated with interests in the same property that

are includable in the gross estate pursuant to other sections of the Internal Revenue Code. Thus, the estate was able to discount the fractional shares held in each trust to reflect lack of marketability and minority interests (*Estate of Lopes v. Comm'r*, TC Memo. 1999-225, 7/8/99).

### Severed QTIP Causes Gift

A QTIP trust was severed into two trusts and the surviving spouse proceeded to execute a nonqualified disclaimer of her interest in one of the trusts. As a result, a taxable gift of the disclaimed assets took place. However, severance of the trust did not result in a "disposition" of the spouse's interest in the second trust for purposes of IRC Sec. 2519(a). Severance of the QTIP trust was permitted under state law and the remaining QTIP trust was subject to the same terms as the original QTIP trust. Thus, no gift was made from the second QTIP trust (PLR 199926019).

### Tax on Disclaimed Property

An estate worth \$4 million was held in a revocable trust. Certain designated assets were to pass to a marital trust but the surviving spouse executed a qualified disclaimer of \$2 million of stock. As a result, the stock passed to the decedent's children via the family trust. Since the revocable trust specified that property eligible for the marital deduction was not to be burdened with the payment of estate tax, the tax on the disclaimed assets was to be paid from the residuary bequest, i.e., from the disclaimed stock, and not from the rest of the assets passing to the marital trust (TAM 199924002).

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