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SHOULD USE OF QTIPS BE ADVISED? DO NOT DISMISS THIS MARITAL DEDUCTION VEHICLE OUT OF HAND

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The Internal Revenue Code (IRC) provides preferential estate tax treatment for testamentary transfers between spouses by granting an unlimited estate tax marital deduction for assets passing from a decedent to or for the benefit of the decedent's spouse in a variety of ways. The most common methods are as an outright bequest to a surviving spouse and as qualified terminable interest property (QTIP) in trust for the benefit of a surviving spouse.

Although one might view the unlimited marital deduction as a generous act by Congress, the generosity ends at the death of the surviving spouse, when the bequeathed assets — whether distributed to her outright or held in a QTIP trust — will be taxed in her estate to the extent such assets are not consumed during the remainder of her life. Thus, the marital deduction simply defers (rather than eliminates) the estate tax on a decedent's assets. Nonetheless, most clients prefer deferral for psychological reasons (i.e., paying a tax later is preferable to paying a tax now), even if total deferral ultimately may be less beneficial financially as one forgoes the use of the lower estate tax brackets in the first estate.

As the majority of clients favor marital deduction planning, estate planning, practitioners must be fully prepared to advise them as to their various options. Although most surviving spouses prefer to receive assets outright, it may be more beneficial from both a wealth distribution and an estate tax perspective to place the assets into a QTIP trust. Thus, in selecting the appropriate marital deduction vehicle, clients and practitioners should not dismiss the QTIP alternative out of hand but, rather, should closely evaluate the attendant benefits and pitfalls of utilizing such a trust in a client's estate plan before arriving at a decision.

What Is a QTIP Trust?

A trust must meet all of the following conditions in order to be a QTIP trust and thereby qualify for the marital deduction:

- The trust must be funded in whole with assets that passed from the decedent.
- The surviving spouse must be entitled to all trust income during life, to be distributed at least annually.
- No person, including the surviving spouse, may have the power to divert any trust property to anyone other than the surviving spouse during such spouse's lifetime.

The decedent's executor must make the QTIP election on the decedent's estate tax return.

The Benefits

Given a particular client's marital circumstances, a QTIP trust may be a more appropriate way to pass property to a surviving spouse than an outright bequest. Perhaps the most touted use of QTIP trusts is in the second marriage context. If a testator with children from a prior marriage leaves an outright bequest to his spouse, the surviving spouse has no obligation to provide for such children in her estate plan. However, by creating a QTIP trust and designating his children as the remaindermen, the decedent can prevent the ultimate diversion of assets from his children while ensuring that his spouse is adequately provided for during her lifetime.

A QTIP trust may also benefit a surviving spouse by protecting her from the mismanagement of the decedent's assets, either by others or herself. For example, if the surviving spouse is elderly, incapacitated or simply too trusting, the trustees of her QTIP trust will presumably protect the trust assets from unscrupulous money managers. Or, if the surviving spouse has unwise or excessive spending habits, a client may use a QTIP trust to protect the spouse from her tendency to mismanage money.

The use of a QTIP trust can also provide substantial savings (up to as much as $566,500) by avoiding generation-skipping transfer (GST) taxes for a client who wishes to make testamentary transfers to grandchildren or more remote descendants. Transfers of property that skip a generation (e.g., transfers to grandchildren) are taxed at a flat rate of 55 percent in addition to any estate tax incurred on such transfers. However, every individual may make up to $1,030,000 of such transfers free of GST tax. The benefits of utilizing a QTIP trust to save GST taxes can be illustrated by comparing the results of the following two scenarios:

First, assume a decedent leaves his entire estate outright to his spouse. Under these facts, use of the decedent's GST exemption would not be necessary (or possible), since there is no generation-skipping transfer. Upon the subsequent death of the surviving spouse, her executor may elect to utilize her $1,030,000 GST exemption for transfers to grandchildren. Since the GST exemption of only the surviving spouse is used, the decedent's exemption was wasted up to a cost of $566,500 — the GST tax on $1,030,000.

In the second scenario, assume the decedent creates a QTIP trust under his will that is funded with $1,030,000. Assume as well that a reverse QTIP election under IRC § 2652(a)(3) is then made with respect to the trust. A reverse QTIP election treats the decedent, rather than the surviving spouse, as the transferor of the QTIP assets for GST purposes upon the death of the surviving spouse.

By making such an election, the decedent's GST exemption can be applied to the QTIP assets and the surviving spouse's GST exemption can be applied to her separately owned assets; so that neither of the exemptions is wasted. Practitioners should note, however, that the reverse QTIP election must be made on the decedent's estate tax return to obtain the benefits of this planning technique, as a typical QTIP election would treat the surviving spouse as the transferor, leading to the same result as in the first scenario described above.

The 'Mellinger' case

The creation of a QTIP this is also beneficial for a client who holds a controlling interest in a closely-held company, because it may lower the estate tax bite on the death of the surviving spouse.

In the Tax Court's recent decision in *Mellinger Est.* v. *Comr*, 112 T.C. 4 (1999), the court ruled that a minority interest in a closely held corporation which was held in a QTIP trust should not be aggregated for estate tax purposes with a minority interest in the same corporation which was separately held by the surviving spouse's revocable trust. The court rejected the Internal Revenue Service argument that the two minority interests should be aggregated to create a majority interest which would eliminate any minority discounts. As a result, the court allowed a 31 percent discount to be applied both to the minority interest in the QTIP trust and the minority interest in the revocable trust.

In light of *Mellinger*, clients may want to bequeath shares of closely held stock to a QTIP trust and ensure that the surviving spouse will have, separate from the QTIP trust, other closely held shares as part of her estate. By doing so, significant valuation discounts may be taken, reducing the estate tax due upon the death of the surviving spouse.

The benefits of a QTIP trust can be obtained when the surviving spouse is not a U.S. citizen only by creating a type of QTIP trust with additional requirements described in IRC § 2056A —a qualified domestic trust, or QDOT. The code only allows the marital deduction for testamentary transfers to or for the benefit of a non-citizen spouse if either (i) the surviving spouse becomes a U.S. citizen prior to the filing of the decedent's estate tax return and was a U.S. domiciliary from the date of the decedent's death until the date of naturalization, or (ii) the assets are transferred into a QDOT. In addition to the QTIP requirements, a QDOT must also meet the following conditions in order for the marital deduction to apply:

- At least one trustee must be a U.S. citizen or domestic corporation.
- A U.S. trustee must have the right to withhold the tax imposed on any principal distributions.
- The administration of the trust must be governed by the laws of a particular state of the United States or the District of Columbia.
- The trust must either (i) have at least one trustee that is a U.S. bank or trust company, (ii) furnish a bond or letter of credit equal to 65 percent of the trust's estate tax value or (iii) if the trust's estate tax value is less than $2 million, prohibit investment of greater than 35 percent of the trust's annually determined fair market value in off-shore real estate.

The QDOT also differs in how it is ultimately taxed. Similar to a QTIP trust for a U.S. citizen spouse, no estate tax is due upon the death of the decedent. However, a distribution of principal from the QDOT will generate an estate tax (subject to an exception for distributions on account of "hardship"), equal to the additional estate tax that would have been generated if the decedent's taxable estate had been increased by the amount of such distribution.

Thus, while principal payments from a typical QTIP trust would not be taxed at the time of distribution and, if consumed or otherwise disposed of by the surviving spouse before her death, would never be taxed at all, the same distribution from a QDOT would be immediately subject to estate tax. Although a QDOT is more onerous to administer and its tax treatment is not as beneficial as that of a typical QTIP trust, the avoidance of the alternative — the payment of estate tax upon the decedent's death — along with the other benefits of a QTIP trust described above, may make the creation of a QDOT worthwhile, particularly if the income from the QDOT is sufficient to support the surviving spouse during her life and invasions of principal will be minimal.

Pitfalls of QTIP Trusts

Even though the benefits of QTIP trusts are numerous, their potential pitfalls should not be ignored. For example, when a QTIP trust is used in the second marriage context, the client should be made aware of the difficulty trustees fact in the context of their fiduciary duty to balance the conflicting interests of the surviving spouse with those of the client's children of a prior marriage.

In managing the assets, the trustees will be pulled between investing in income-producing assets that currently benefit the surviving spouse, and investing in growth assets that will ultimately benefit the children. Also, to ensure maximum flexibility, the governing instrument often gives trustees the power to make discretionary principal distributions from the trust to the surviving spouse. However, because of the children's remainder interest, it may be difficult for the trustees to exercise the discretion. They may err on the side of caution and not make principal distributions that are as generous as the decedent may have contemplated when he gave the trustees such discretion under his will. On the other hand, being too generous with distributions to the surviving spouse may anger the remaindermen, who may accuse the trustees of not preserving their interest in the trust.

Administrative Items

There are a number of administrative procedures in connection with the creation of a QTIP trust which, if not handled correctly, could lead to unfavorable tax consequences. For example, if a decedent's will gives his entire estate to his spouse in a form that meets the QTIP requirements, and if the decedent's executor makes a full QTIP election, all of the assets would pass tax free as a result of the marital deduction. However, the decedent's applicable credit amount, i.e., the opportunity to pass $675,000 free of tax, would then be wasted. This result can be avoided by making a partial QTIP election.

The election should not be made to the extent that the decedent's property can be exempted from estate tax by reason of the applicable exclusion amount. Thus, if a decedent dies In the year 2000 with $1,000,000 of assets, the executor should make a partial QTIP election of 32.5 percent of the property in the trust ($325,000 + $1,000,000), since the tax on the balance of the estate, $675,000, would be reduced in full by the use of the decedent's applicable credit amount.

Another administrative pitfall arises if a client intends to make generation-skipping transfers and utilizes a QTIP trust coupled with a reverse QTIP election, as described above. This planning technique requires that two separate QTIP trusts be created, because a partial reverse QTIP election cannot be made. The executor must (i) fund one QTIP trust in the exact amount needed to fully utilize the decedent's GST exemption and elect reverse QTIP treatment with respect thereto, and (ii) fund a separate QTIP trust with the balance of the estate property that passes to a QTIP trust under the will.

By funding two trusts, the GST tax savings are maximized. If the will does not create two separate QTIP trusts at the outset, the executor must divide the single trust into two, either pursuant to the governing instrument or state law. If reverse QTIP treatment is elected without this division, the reverse QTIP trust could be larger than the decedent's GST exemption, resulting in an inefficient application of the decedent's GST exemption (i.e., an inclusion ratio between 0 and 1).

A QTIP election may not be desirable if the surviving spouse is in poor health and will be unlikely to survive the decedent by at least 10 years. The actuarial value of the surviving spouse's lifetime interest in a trust which does not qualify for the marital deduction would qualify for the credit for previously taxed transfers under IRC § 2013 if the surviving spouse dies within 10 years of the decedent. Therefore, if it seems likely that the surviving spouse will die in the near future, it would be advisable for the executor not to make the QTIP election but, instead, to incur tax on the transfer to the trust. By doing so, the effect of estate stacking (i.e., failing to use the lower estate tax brackets in the estate of the first spouse to die) will be avoided.

Conclusion

In advising a client on his estate plan, a practitioner must be cognizant of the benefits and pitfalls associated with QTIP planning. While, at first blush, clients may view an outright bequest to a surviving spouse as more desirable, a practitioner should not quickly dismiss the possibility of using a QTIP trust. Rather, the practitioner should advise his client of the benefit, and pitfalls associated with QTIP planning to determine whether a QTIP trust should be used in light of such client's particular circumstances.

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