FEATURE:
ESTATE PLANNING & TAXATION

By **Christopher Siegle**

Time to Rethink the Typical Testamentary QTIP Trust?

Additional approaches to planning with this vehicle

Many advanced estate planners emphasize to their clients the benefits and features of lifetime planning. The estate-planning community has become accustomed to using common and catchy labels for such planning techniques, for example, spousal lifetime access trusts (SLATs), grantor retained annuity trusts (GRATs), charitable lead annuity trusts (CLATs) and beneficiary defective inheritors trusts (BDITs).

Despite their maturity, and the growing popularity of other techniques applicable in somewhat idiosyncratic fact patterns, such as spousal lifetime non-grantor trusts, net income make-up charitable remainder unitrusts and incomplete gift non-grantor trusts, many clients conclude that their well-drafted revocable trust, which will create both a qualified terminable interest property (QTIP) trust and credit shelter (or bypass) trust (CST), will be the vehicle that carries most of their wealth to the next generation and, at that, only on the death of the surviving spouse.

Planning for Married Couples

The Economic Recovery Tax Act, passed in 1981,[1] allowed an unlimited deduction on the transfer of wealth to—or in trust for the benefit of—a surviving spouse (originally whether or not the recipient was a citizen), provided certain criteria are met. Combined with an existing law exempting a fixed dollar amount passing to a decedent's beneficiares free of U.S. estate tax, that law provided planners with the common structure—one that's lasted to this day—for a married couple's estate plan.

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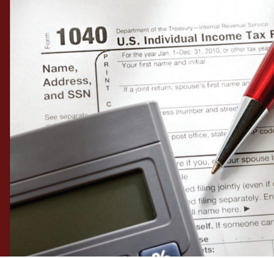
That structure directs, more or less, that, on the death of the first spouse to die, the maximum amount that can pass free of U.S. estate tax passes into a CST, with the balance being either distributed outright to the surviving spouse or held in trust for the benefit of the survivor. Using such a structure means that a married couple should owe no U.S. estate taxes until the survivor's death.

Today, regardless of whether the decedent resided on passing in a separate property, community property or all-property state, the decedent's share of the married couple's property could fund a CST to hold the decedent's unused lifetime exclusion.

In most cases, the decedent spouse's remaining property would, if not distributed outright to the surviving spouse, fund a testamentary QTIP trust.[2] The assets in this QTIP trust would be included in the gross estate when the surviving spouse later passes, pursuant to Internal Revenue Code Section 2044. And that's often the end of the planning for married clients who, during their lives, can't afford to part with or resist giving up control of their assets. But there are significant planning opportunities involving testamentary QTIP trusts beyond merely deferring the estate tax until the surviving spouse's passing.

QTIP Trust Basics

A trust will qualify as a testamentary QTIP trust if it meets at least the following three criteria: (1) the property passed from a decedent to a surviving spouse; (2) the surviving spouse had a "qualifying income interest" in the property for life; and (3) the executor of the the deceased spouse's estate made an



election on the decedent's estate tax return under IRC Section 2056(b)(7). A qualifying income for interest for life means, basically, that the surviving spouse is entitled to all income at least annually (or has a usufruct interest) for life and that no one has any power to appoint any part of the property to anyone other than the surviving spouse.[3] Despite the enormous wealth held across the country in countless thousands of testamentary QTIP trusts created in the more than four decades since the enactment of the law permitting an unlimited marital deduction, many planners remain hesitant to work with these trusts because of the complexity of the qualifying income interest rules.

Additional Approaches

Here are additional approaches to planning with the testamentary QTIP trust:

Changing the income tax owner. A testamentary QTIP trust is a non-grantor trust. The surviving spouse must be entitled to receive the qualifying income interest at least annually. As a result, the trust becomes eligible for an income tax deduction based on its distributable net income (DNI), and the beneficiary includes the DNI amount in their taxable income.[4]

A planning opportunity—whether created in new trusts or through a decanting or trust modification of an existing trust—is to first structure the qualifying income interest as an expanded right of withdrawal over *all* the trust's taxable income.

The idea here is to expand the meaning of "income." Traditionally, "income" in the fiduciary context has most often meant the trust's fiduciary accounting income (FAI). IRC Section 643(b) provides that items of interest, rents and cash dividends are considered FAI. FAI typically *doesn't* include the gain from the sale or exchange of trust property.

However, income can be defined differently. The easiest way to include capital gains in FAI is to provide in the trust instrument that capital gains be included in the defintion of FAI. That provision will be effective if local law supports it. By including gain as income, the qualifying income interest, whether FAI or the broader concept of taxable income generally, would be "income." The trust could then give the surviving spouse a withdrawal right over all of the trust's taxable income, which would include capital gains.[5] This unrestricted right of withdrawal should be provided to the surviving spouse without requiring any consent or approval by the trustee.[6]

A testamentary QTIP trust that grants the spouse the right to withdraw over all the taxable income would result in a trust in which the spouse would be considered the owner of *all* the trust's assets for income tax purposes under IRC Section 678(a)(1). The spouse would therefore have the power to acquire the trust assets by substituting other property of equivalent value without any consent or approval of any fiduciary under IRC Section 675(4)(C). That would give the surviving spouse the ability to transact with the QTIP trust itself in a tax-free manner, thereby adding significant flexibility to the management of the survivor's overall wealth. (Another Section 678 power is to borrow trust assets without interest or security under Section 675(2)). However, exercising either of those powers may trigger gift tax consequences under IRC Section 2519, so practitioners should be mindful not to accidentally trigger that section.

> In *Kite*, the court confirmed that a spouse could sell assets of a testamentary QTIP trust to a third party in exchange for annuity contracts without triggering Section 2519.

Avoid Section 2519. Section 2519 provides that any "disposition" of any portion of the qualifying income interest of a surviving spouse will cause gift tax liability for the entire value of a testamentary QTIP trust property, less the value of the qualifying income interest itself. This is so even though that trust property wasn't part of the disposition.[7] Any transfer

of the qualifying income interest is then considered as a separate taxable gift under IRC Section 2511.[8] Clearly, the risk to planning is a draconian current taxable gift tax inclusion of all the trust assets if even a small disposition is made. Despite that risk, there are several planning ideas to be explored.

Sell the assets for value to another grantor trust. As commonly structured, the grantor of a trust sells assets to an irrevocable grantor trust in exchange for a term promissory note with a balloon principal repayment at the conclusion of the term. In most cases, the trust is completely generation-skipping transfer (GST) tax exempt because GST tax exemption was allocated on a U.S. gift tax return, Form 709, when a seed gift was made. This approach—make a gift to an irrevocable grantor trust and then sell assets to the trust for a note—is generally accepted as one of the most powerful techniques to freeze the value of the sold assets and indirectly transfer any expected future appreciation to a GST tax-exempt trust.

Nowell v. Comm'r confirms that valuation discounts and separateness arguments are available.

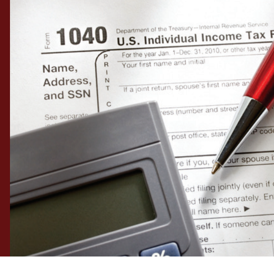
There's rightful concern that any transfer from the testamentary QTIP trust will be a disposition of a qualifying income interest. However, this fact pattern was the subject of *Estate of Kite v. Commissioner*, a 2013 Tax Court memorandum decision.[9] In that case, the court confirmed that a spouse could sell assets of a testamentary QTIP trust to a third party in exchange for annuity contracts without triggering Section 2519. The key element identified by the court was that the spouse remained the sole income beneficiary of the trust and was thus entitled to receive the income provided by the annuity contracts. Further, the court evaluated the sale transaction under Section 2036 standards of being a bona fide sale for adequate and full consideration.[10]

Section 2519 provides that a conversion of the assets isn't treated as a disposition of the qualifying income interest of the surviving spouse.[11] A conversion of the trust assets is a change in the form and character of the trust assets that provide the qualifying income interest. A trustee's management of the trust's assets via buying and selling doesn't constitute a disposition for Section 2519 purposes. In the context of selling the trust assets for value in exchange for a promissory note, because the note produces income to the testamenarty QTIP trust (in the form of interest income, if that's been defined in the QTIP trust document), and the face amount of the note reflects the fair market value of the sold assets, there's been no disposition of the qualifying income interest.

With *Kite* as precedent (to the exent a Tax Court memorandum case is precedential), one can consider that the sale of assets by the spouse to a GST tax-exempt irrevocable grantor trust settled by the spouse could be a good option so long as: (1) the terms of the promissory note made by the trust reflect a positive investment for the testamentary QTIP trust; (2) the transaction constitutes a bona fide sale for full and adequate consideration standards; and (3) the property sold is valued with precision.

Valuation is a key to satisfying the full and adequate consideration prong of the bona fide sale standard. If the assets that are being sold to the trust are hard to value, then using a defined value clause to protect the integrity of the transfer for valuation purposes can be very helpful. Because the excess of any revalued assets beyond the face amount of the promissory note would have to be returned to the testamentary QTIP trust from which the assets were sold, a *Wandry*-style formula clause could be useful.[12] In *Wandry* and other defined value transfer clause cases, a formula in the trust provides that if the value is later, on audit, determined to be greater than the value originally desired, thus subjecting the donor to potentially unexpected gift tax, the excess portion will revert to the donor or otherwise be ignored as a taxable transfer.

Applying the idea of creating a trust that would be considered a grantor trust, thanks to Section 678(a)(1), vis-a-vis the beneficiary/surviving spouse



of the testamentary QTIP trust, the trust's sale of assets to a GST tax-exempt irrevocable grantor trust should result in no recognition of income by the testamentary QTIP trust when it receives interest payments. Those payments are from one trust to the other, both of which are deemed owned by the surviving spouse for income tax purposes. This income tax efficiency can allow the surviving spouse to receive at least some of the qualifying income interest tax free.

Planners may be concerned about aggregation of testamentary QTIP trust interests and other interests in the surviving spouse's estate. *Nowell v. Comm'r*[13] confirms that valuation discounts and separateness arguments are available.

Form a preferred partnership. Another option for the testamentary QTIP trust is to create a partnership with the GST tax-exempt irrevocable grantor trust. Under the partnership agreement, the testamentary QTIP trust could contribute its assets in exchange for a preferred partnership interest. Conversion of trust assets,—which is a contribution in exchange for the interest of equivalent value, shouldn't be a disposition of the qualifying income interest for Section 2519 purposes. The preferred interest could be calculated to provide the same or greater (or lesser) level of income than the testamentary QTIP trust had been receiving as the spouse's qualifying income interest before the contribution. A second entity, perhaps a GST tax-exempt irrevocable grantor trust, or the CST with Section 678 features as to the surviving spouse, could contribute some or all of its assets and be a partner and receive common (meaning junior) interests in the partnership.

With the partnership in place, the receipt of the preferred interest distributions from the partnership to the testamentary QTIP trust would be income that would be distributed to the spouse as a qualifying income interest. This structure may provide greater cash flow to the testamentary QTIP trust, and therefore the spouse, than if the partnership hadn't been created. Further, the accretion of value in the common interest held in a GST tax-exempt irrevocable grantor trust that's outside of the estate of the surviving spouse can provide dynastic advantage for the spouse's issue. Depending on the state law where the trust is settled, the spouse could enjoy investment direction control and have other control over the GST tax-exempt irrevocable grantor trust, which may be another attractive feature of this approach.[14]

Use the Section 2056 portion rule. The QTIP trust beneficiary must always receive the qualifying income interest of the trust. Sometimes the trust property consists solely of a single, valuable asset, such as a business interest or real estate. Another planning idea is to structure the testamentary QTIP trust to use the rule in Treasury Regulations Section 20.2056(b)-7(d)(2) to allocate a portion of the marital gift to the testamentary QTIP trust and another portion containing the optimum property interest for later transfer by sale or loan to a separate marital trust with a general power of appointment (GPOA) marital trust under Section 2056(b)(5).

The QTIP election can be a partial, applicable to only some of the assets. The testamentary QTIP trust has a portion rule that gives options to the trustee.[15] Treas. Regs. Section 20.2056(b)-5(c)(2) provides that the two portions available are a fractional or percentage interest. A portion constitutes a fraction or percentage of the entire property, so that the spouse's qualifying income interest within the testamentary QTIP trust reflects a proportionate increase or decrease in the value of the property.

Planning carefully and with due regard to the tax rules to shift future growth from a testamentary QTIP trust into GST tax-exempt trusts can be immensely satisfying to the benefited families.

The portion rule, whether under Section 671 or Section 2056, is often underappreciated but could

be emphasized in the planning as a tool to create separate interests in the trust's property.[16]

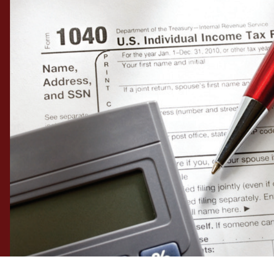
Here's an illustration regarding use of the Section 2056 portion rule: Suppose the property available for a marital deduction is composed of a single asset, and further wealth transfer is contemplated with the testamentary QTIP trust assets. Consider using the Section 2056 portion rule to allow either a percentage or fractional share to be allocated to a testamentary GPOA marital trust, with the corresponding other portion allocated to a testamentary QTIP trust. Selecting the portion with the greatest growth potential for the testamentary GPOA marital trust is potentially advantageous, because more planning could be undertaken with those trust assets. Using a percentage or fractional share can preserve the surviving spouse's qualifying income interest in the testamentary QTIP trust and accomplish wealth transfer without any risk of triggering Section 2519. The portions could also be helpful to produce potential valuation discounts when selling assets to the GST tax-exempt irrevocable grantor trust or contributing property to the preferred partnership. Finally, the estate tax value of the separate portions of the surviving spouse's estate should be eligible for discounting or a control premium for the interest with optimum control features.[17]

Revocable Trust Planning

Because of several factors, including a couple's reluctance to give away resources during their lifetimes, give up control or engage counsel, there are large testamentary QTIP trusts that are deferring but not eliminating estate tax. Many of the powers, elections and decisions enabling post-mortem planning for the marital trust must be included in the language of the revocable trust, for example, expanding the trustee power provision to include forming preferred partnerships, or including the Section 678 withdrawal powers. Otherwise, state law options such as decanting and non-judicial settlement may be needed after the first spouse dies. Undertake the planning for the marital trust assets before the first spouse passes and after the passing of the first spouse. Planning carefully and with due regard to the tax rules to shift future growth from a testamentary QTIP trust into GST tax-exempt trusts can be immensely satisfying to the benefited families.

Endnotes

1. *See* the Economic Recovery Tax Act of 1981, Pub Law 97-34, Section 403(d)(1), adding Internal Revenue Code Section 2056(b)(7), applicable for decedents dying after Dec. 31, 1981. From 1948-1981, the maximum that could pass to a surviving spouse free of estate tax was 50% of the decedent's gross estate.
2. In contrast to another planning vehicle, a lifetime marital qualified terminable interest property (QTIP) trust. *See* Richard S. Franklin and George D. Karibjanian, "The Lifetime QTIP Trust—the Perfect (Best) Approach to Using Your Spouse's New Applicable Exclusion Amount and GST Exemption," *Tax Management Estates, Gifts, and Trusts Journal,* Vol. 44, No. 2 (March 14, 2019).
3. *See* IRC Section 2056(b)(7)(B)(ii).
4. *See* IRC Sections 651, 652 and 643. Distributable net income (DNI) is established in Section 643. Consider including capital gains into DNI under Treasury Regulations Section 1.643(a)-3(b). A trust receives a deduction for the DNI it distributes within 65 days of the close of any year under Sections 651 and 663(b). The surviving spouse, as the beneficiary of the trust, includes the DNI in their gross income when received under IRC Section 652.
5. The definition of "income" in most revocable trusts is focused on a trustee's discretion to allocate items among principal or income. Planners should go beyond the boilerplate and actively define income and total income.
6. *See* IRC Section 678(a)(1).
7. *See* IRC Section 2519(a).
8. *See* Treas. Regs. Section 25.2519-1(a).
9. *Kite v. Commissioner,* T.C. Memo. 2013-43.
10. *See Kimbell v. United States*, 371 F.3d 257, 265 (5th Cir. 2004).
11. *See* Treas. Regs. Section 25.2519-1(f).
12. *See Wandry v. Comm'r*, T.C. Memo. 2012-88.
13. *See Nowell v. Comm'r*, T.C. Memo. 1999-15.
14. *See* Section 6, Uniform Directed Trust Act (2017); IRC Section 2036.
15. The IRC Section 2056 portion rule is more restrictive than the grantor trust portion rule of Treas. Regs. Section 1.671-3, which identifies six portions of a grantor trust.
16. *See ibid.*
17. *See Nowell, supra* note 13; *see also Chenoweth v. Comm'r*, 88 T.C. 1577 (1987), sustaining a control premium under Section 2056.



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