<u>QTIPs Offer New Estate Tax Saving Opportunity</u>

(***Intervivos QTIPs***)

By: John L. Pritchard, Esq.

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Despite all the difficulty encountered in sophisticated estate planning, there is one area in which the I.R.S. has recently made planning easier for certain married couples. It has to do with Qualified Terminal Interest Property trusts ("QTIP"s) created while both spouses are living, and allows for greater flexibility where one spouse holds the great majority of the couple's assets.

In computing a decedent's Federal estate tax, the unified credit allows each person to leave up to $600,000 free of estate tax. In addition, any property left to a surviving spouse qualifies for the marital deduction, allowing these assets to also pass free of estate tax. On all other assets a tax is imposed at a rate starting at 37 percent, which quickly rises to 53 percent on estates in excess of $2.5 million, and 55 percent on estates in excess of $3.5 million. With such high rates, anything which can decrease the taxable estate will attract attention from clients and their professional advisors.

For tax purposes it is not prudent for a person to leave his entire estate outright to a surviving spouse, because that unnecessarily builds up the spouse's taxable estate. Instead, it is usually better to leave the first $600,000 to a "credit shelter trust" for the benefit of the surviving spouse, and leave all else to the surviving spouse. The credit shelter trust will pay all its income to the surviving spouse for life, and allow for invasions of principal, without being part of the taxable estate of the surviving spouse.

In this way a couple can make use of the $600,000 credit equivalent of each of them, allowing them to leave up to $1.2 million free of Federal estate tax.

<u>The Problem of the Less-Wealthy Spouse or the Judgment-Proof Spouse</u>.

One problem with the above plan is that its full use requires the couple's assets be divided between the two of them, until each of them has $600,000 in his or her own name. For example, if the husband has $900,000 in his name, and the wife has very little, then if the wife passes away first the family will lose the benefit of her unified credit. On the later death of the husband the first $600,000 will pass tax free, but $300,000 will be subject to taxes of at least 37 percent. The tax will be even higher if the assets appreciate before the death of the second spouse.

The obvious solution is for the husband to give half his assets to his wife, but there will often be objections to this. It could be that he does not trust her with the money, or is concerned that she may leave the assets by will to persons other than those he would choose, or is worried about the consequences of divorce.

Such concerns will be even more likely where the wealthier spouse has children from a previous marriage. In addition, all the assets of a couple may be held by one spouse if the less-wealthy spouse wishes to remain judgment-proof.

An appropriate solution for this problem may be for the wealthier spouse to create an "intervivos QTIP trust" for the benefit of the other spouse while both of them are alive. Under the Internal Revenue Code this would be a "Qualified Terminal Interest Property Trust" of the same type sometimes used in a will for the non-credit shelter portion of the estate.

There would be no gift tax on the creation of the intervivos QTIP because it is for the benefit of a spouse and the marital deduction applies if an appropriate election is made on a gift tax return. All the income would be payable to the donee spouse for his or her entire life, and thereafter the principal will pass as directed by the original trust agreement signed by the grantor.

The Interest in a Reversionary Interest.

The key difficulty with the use of an intervivos QTIP has been that after the death of the less-wealthy spouse the donor spouse will usually want the trust to benefit himself or herself, without causing the trust to be included in his or her own taxable estate.

Formerly it was commonly believed that if one spouse created the trust for the other, with the provision that upon the donee's death the trust income would be directed back to the donor, the entire trust would then be included in the donor's taxable estate. This would defeat the purpose of the intervivos QTIP.

Private Letter Rulings issued by the I.R.S. were inconsistent as to whether a retained reversionary interest for the grantor would cause the trust to be included in the grantor's taxable estate, if the grantor survived the donee spouse. Sometimes the I.R.S. held that the reversionary interest required the inclusion in the grantor's estate. PLR 8944009, PLR 9007015, PLR 9026036. Sometimes the I.R.S. held that the reversionary interest did not require the inclusion in the grantor's estate. PLR 9140069, PLR 9437032. Commentators were divided on the issue. See Tax Management Portfolio No. 239-4th (EGT), at A-43, 44.

Several techniques were used by attorneys and accepted by the I.R.S. to avoid the reversionary interest problem, including "Crummy trust" provisions and general powers of appointment held by the donee spouse. These techniques required frightening levels of complexity and a further loss of control over the assets by the client.

The Pro-Taxpayer Resolution of the Issue.

The proposed I.R.S. regulations regarding QTIPs issued in 1984 did not address the treatment of reversionary interests. However, in February, 1994, the IRS issued the final version of Treas. Reg. 25.2523(f)-1, adding Examples 9, 10 and 11, which resolved the matter in favor of the taxpayers.

In Treas. Reg. 25.2523(f)-1(f)(Example 11), Donor-Spouse creates a intervivos QTIP for Donee-Spouse, and in the trust instrument provides that upon Donee's death the current income will be paid to Donor-Spouse for life. Donee Spouse then dies first. The example holds that the trust will not be included in the Donor-Spouse's taxable estate upon his or her death.

The first private letter ruling following the new regulation is PLR 9437032, issued June 20, 1994, in which the Donor had an income interest after the Donee's death. The Donor irrevocably gave up the right to serve as trustee, though it is not clear if this is necessary. The trust was held not includible in the Donor's taxable estate if the Donor survived Donee.

Flexibility in Planning.

The key to the new Treas. Reg. 25.2523(f)-1(f)(Ex. 11) is a broader and more literal reading of I.R.C. 2044(c), which states that a QTIP trust is deemed to have been created by the donee spouse at the time of the donee spouse's death, and the inclusion of the QTIP trust in the donee's taxable estate. This means that the donor will not be treated for tax purposes as the beneficiary of a self-created trust.

Any reversionary interest back to the grantor-donor should be structured so all the income is payable to the grantor for life, and should meet all other requirements of a QTIP. Assume for example that Wife creates an intervivos QTIP for Husband containing $600,000 of stocks. The stocks increase in value to $675,000 prior to Husband's death. Wife survives him, and as his executrix makes a QTIP election on his estate tax return for $75,000 of the trust. The remainder of the trust is treated as a credit shelter trust, and will not be included in her taxable estate. The excess $75,000 is not taxed in his estate because it qualifies as a QTIP.

The credit shelter reversionary trust for the grantor-donor may apparently include an invasionary power for health, education, maintenance and support, with the grantor-donor serving as trustee. There is not yet specific authority on this, however.

With appropriate changes, an intervivos QTIP can be used to make use of the $1 million Generation Skipping Tax exemption of the less-wealthy spouse, including a reverse QTIP election on the part of the reversionary income interest running back to the grantor-donor in excess of $600,000.

An intervivos QTIP with a spendthrift clause can be used to allow a judgment-proof spouse to make use of his unified credit, though the current income (which must be paid out in any QTIP) will be subject to execution.

With the issuance of the new regulations earlier this year, additional opportunities are available for estate planning for married couples in which one of them holds a disproportionate amount of assets. The savings will be so great that it will be well worthwhile for such couples and their advisors to take the steps necessary to make use of the new ruling.