

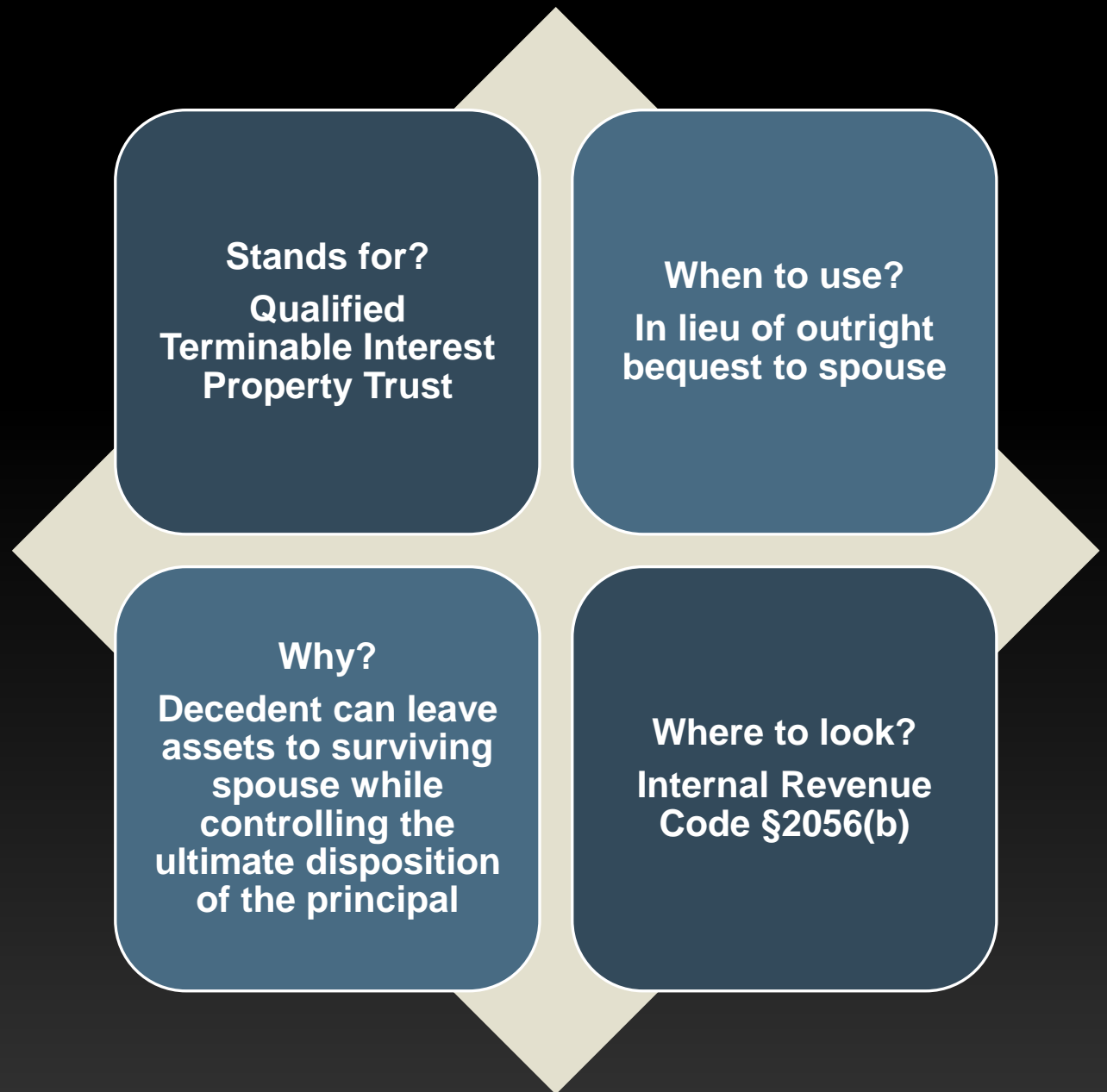
# Planning Beyond the Acronyms: The QTIP Trust

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# QTIP Trust



# What is a terminable interest?

**Treasury Regulations § 20.2056(b)-1(b) defines a "terminable interest" in property as follows:**

A "terminable interest" in property is an interest which will terminate or fail on the lapse of time or on the occurrence or the failure to occur of some contingency.

# When is a terminable interest created?

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A decedent leaves a property interest to his or her surviving spouse

***but***

Leaves another interest in the same property to a third party

***and***

The third party would possess or enjoy all or any part of the property following the termination of the surviving spouse's interest.

Why does  
it matter?

As a general rule, a terminable interest does not qualify for the federal estate tax marital deduction.

# Exceptions – Terminable Interests that Qualify for the Marital Deduction

A property interest qualifies for the Federal estate tax marital deduction, even though an interest in the same property passed from the decedent to a third party, if the interest is terminable because it is:

- Conditioned on the spouse's surviving for a limited period: *to my spouse, if she survives me for six months.*
- A right to income for life with a general power of appointment
- Certain life insurance or an annuity arrangements with a general power of appointment in the surviving spouse
- An interest in a qualified charitable remainder trust in which the spouse is the only noncharitable beneficiary
- Qualified terminable interest property

# Timing matters

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- The determination of whether a terminable interest is deductible is made as of the date of the decedent's death.
- Deductibility is based on the property interest created for the surviving spouse, without regard to any conversions or modifications made to that property interest by agreement, purchase or gift.

# Three requirements to make your terminable interest qualified:

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1. It must *pass from* the decedent;
2. The surviving spouse must have a *qualifying income interest in the property for life; and*
3. An appropriate election must be made.



# Passing from the Decedent

## IRC Section 2056(c)

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- (1) The interest is bequeathed or devised to the surviving spouse by the decedent;
- (2) The interest is inherited by the surviving spouse from the decedent;
- (3) The interest is the dower or curtesy interest (or statutory interest in lieu thereof) of such person as surviving spouse of the decedent;
- (4) The interest has been transferred to the surviving spouse by the decedent at any time;
- (5) The interest was, at the time of the decedent's death, held by the surviving spouse and the decedent (or by them and any other person) in joint ownership with right of survivorship;
- (6) The decedent had a power (either alone or in conjunction with any person) to appoint an interest in property and if he appoints or has appointed that interest to the surviving spouse, or if the surviving spouse takes the interest in default on the release or nonexercise of that power; or
- (7) The interest consists of proceeds of insurance on the life of the decedent receivable by the surviving spouse

## Qualifying Income Interest for Life

Treas. Reg. 20.2056(b)(7)(B)(ii)

The surviving spouse is entitled to receive all of the income from the property in annual or more frequent installments,


and

No one – not even the surviving spouse – has the power to appoint any part of the property directly to anyone other than the surviving spouse.


# Other considerations for the qualifying income interest:

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An income interest established through a trust that is silent as to the frequency of distribution will not fail, unless local law allows payments to be made less frequently than annually.



Income that accrues between the last payment and surviving spouse's death is not required to be paid to the surviving spouse's estate, but it will be included in the surviving spouse's taxable estate.



Including a power to distribute principal to the surviving spouse is permitted, even though the surviving spouse could transfer the same property to a third party.

# The Election

## Treas. Regs. 20.2056(b)-7

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An affirmative election is required.

Made by listing the trust or other property on Schedule M of the decedent's federal estate tax return, Form 706

No box to check.

Filed on or before the due date, including extensions, or

First estate tax return filed by the executor after the due date

# Irrevocability of QTIP election

IRC 2056(b)(7)(B)(v)

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- Once an election is made, it cannot be modified or revoked except on a subsequent return filed *on or before the due date of the return (including extensions)*.
- *Once an election is made on a properly filed return as to certain property, a later QTIP election cannot be made as to additional properties.*

# Voidability of QTIP Election

Rev. Proc. 2016-49

A QTIP election may be voided if:

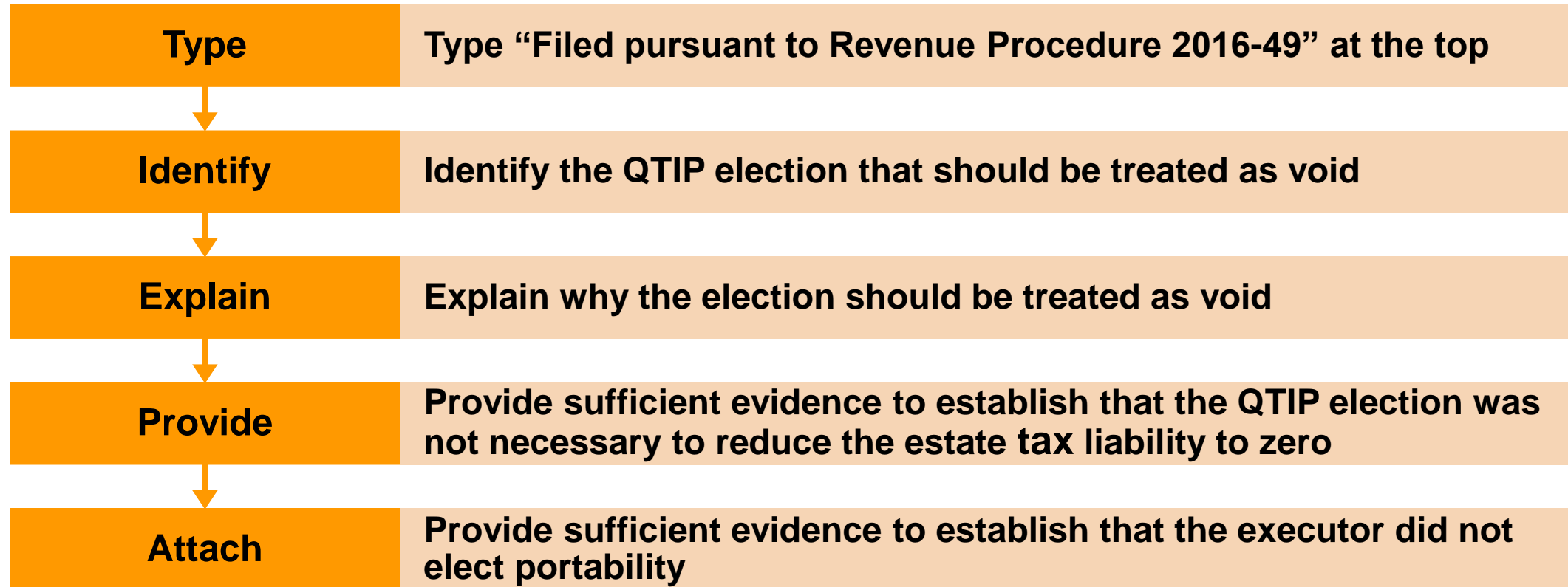
1. The election was not necessary to reduce the estate tax to zero  
*and*
2. The election was not made for portability purposes.

# Requirements to treat QTIP election as void

1. The estate's federal estate tax liability was zero, regardless of the QTIP election (in other words, the election was not necessary to reduce the federal estate tax to zero);
2. The executor of the estate did not make and was not considered to have made the portability election; and
3. The executor submits a supplemental 706 for the predeceased spouse, a Form 709 filed by the surviving spouse or a Form 706 filed for the surviving spouse that notifies the IRS that meets the prescribed requirements.

# Requirements for Supplemental Filing to Treat QTIP Election as Void

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# Formula and Partial Elections

Treas. Regs. 20.2056(b)-7(b)(2)(i)

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**QTIP  
elections  
can be  
made with  
respect to  
less than  
100% of  
the trust  
property**

**Must be made with respect  
to a fractional or percentage  
share of the property so that  
the elective portion reflects  
its proportional share of the  
increase or decrease in  
value of the entire property  
for purposes of applying  
IRC 2044 or IRC 2519.**

# Partial Election Example

Treas. Regs. 20.2056(b)-7(h)  
Examples 7 and 8

## Facts:

Dan's will established a trust funded with the residue of his estate. Trust income is to be paid annually to Sally for life, and the principal is to be distributed to Dan's children upon Sally's death. Sally has the power to require that all the trust property be made productive. There is no power to distribute trust property during Sally's lifetime to any person other than Sally.

# Dan's executor could make a formula partial election by:

Option 1: "I elect to treat as qualified terminable interest property a fractional share of the residuary trust:

- ❖ the **numerator** of which fraction is the amount of deduction necessary to reduce the Federal estate tax to zero (taking into account final estate tax values), and
- ❖ the **denominator** of which fraction is the final estate tax value of the residuary estate (taking into account any specific bequests or liabilities of the estate paid out of the residuary estate)."

Option 2: "I elect to treat as qualified terminable interest property that portion of the residuary trust, up to 100 percent, necessary to reduce the Federal estate tax to zero, after taking into account the available unified credit, final estate tax values and any liabilities and specific bequests paid from the residuary estate." The share is equivalent to the fractional share determined in Option 1.

# Severing a QTIP Trust

Treas. Reg. § 20.2056(b)-7(b)(2)(ii)

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When a partial election is made, it may be wise to divide (or “sever”) the trust and create one "elected" trust and another "non-elected" trust. Requirements:

1. The division must be authorized by the governing instrument or local law.
2. The division must be completed prior to the completion of the administration of the decedent's estate, and if the division has not been completed as of the date that the federal estate tax return is filed, then the intended division must be "unequivocally signified" on the estate tax return.
3. The authority for dividing the trust (the governing instrument or applicable local law) must require that the trust property be allocated between the elected trust and the non-elected trust on the basis of the fair market value of the assets on the division date.
4. The trust must be divided on a fractional or percentage basis (but a pro rata portion of each asset need not be allocated to each trust).

## Effect of a Valid QTIP Election

Trust property qualifies for the marital deduction under Code § 2056(a) for purposes of determining the federal estate tax under Code § 2001,

and

The property will be included in the surviving spouse's gross estate under Code § 2044.

# QTIP Trusts and GST Tax

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The trust property remaining in a QTIP trust at the surviving spouse's death will be subject to federal estate tax as part of the surviving spouse's taxable estate under Code §2044.

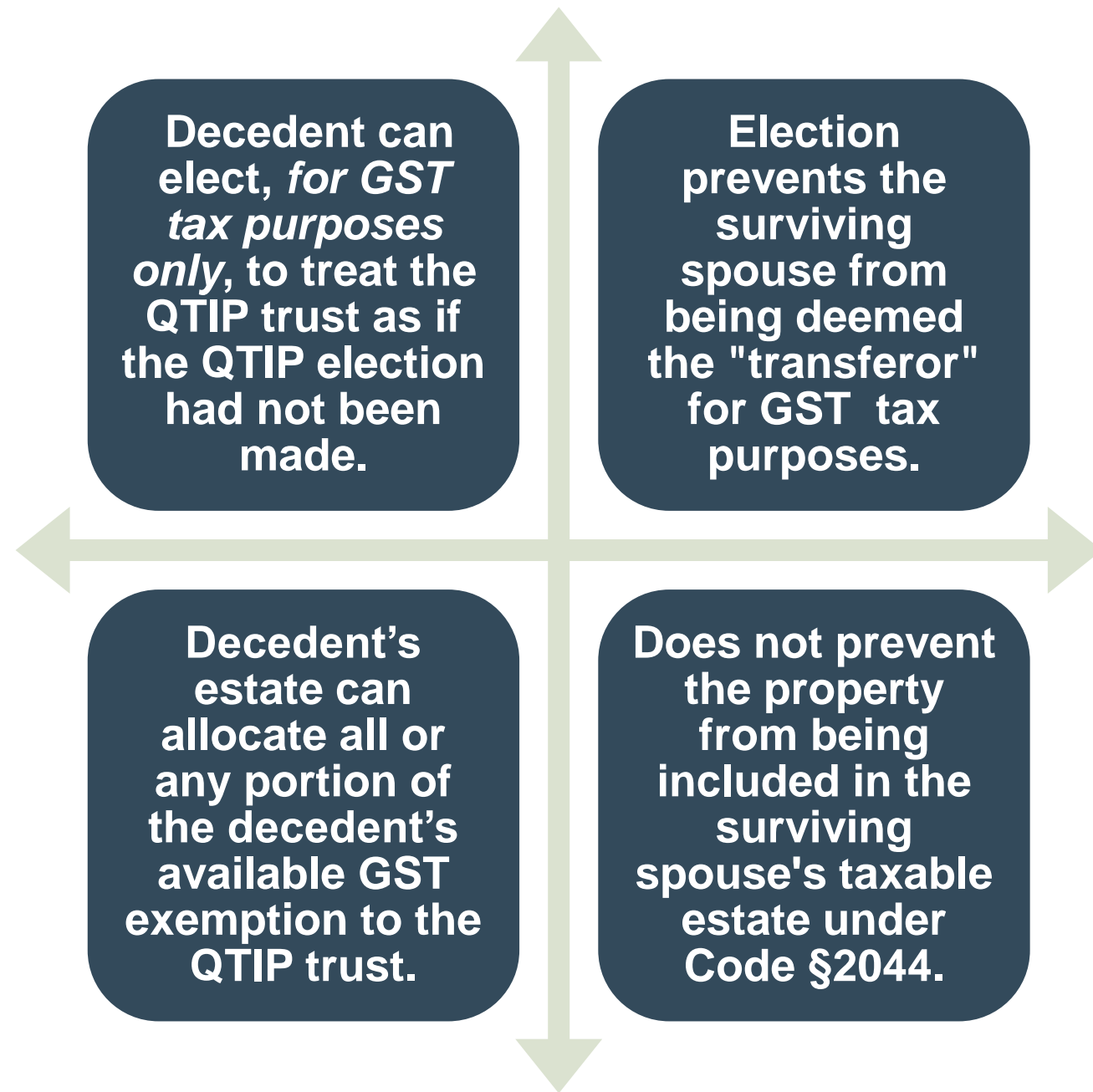


Result: the surviving spouse is treated as transferor of QTIP trust property at the surviving spouse's death.

The decedent cannot allocate any GST exemption to a QTIP Trust that is created as a result of decedent's death

The surviving spouse can allocate his/her remaining GST exemption to the remaining QTIP property at his/her death.

**Exception:  
The Reverse  
QTIP  
Election**  
I.R.C. § 2652(a)(3)



# Lifetime QTIP Trusts

Code § 2523(f)(1)

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Following same concepts, donor can create a QTIP Trust for his/her spouse during life.

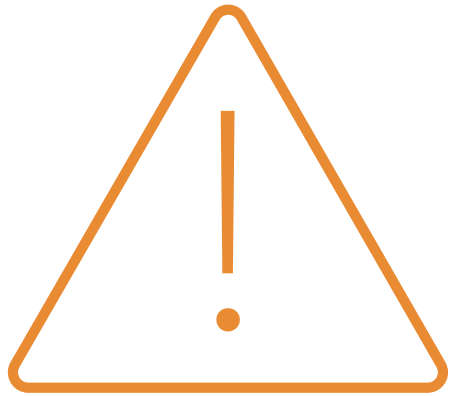
Same rules and concepts apply as to testamentary QTIP Trusts.

Election is made on the donor's federal gift tax return, Form 709.



# Why would you create a lifetime QTIP Trust?

- Control
- If donee spouse predeceases donor spouse, both donee spouse's estate exemption and GST exemption can be applied to the remaining trust property
- Basis adjustment at donee spouse's death



**Risk associated  
with lifetime QTIP  
Trusts:  
Divorce**



# Strategic Planning QTIPs and Portability

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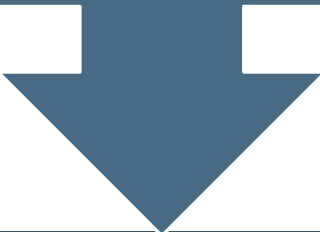
CODE § 2010(C)

TREAS. REGS § 20.2010-2

# Portability In General

Code § 2010(c)  
Treas. Regs §  
20.2010-2

**How to make the election: file an estate tax return for the deceased spouse and don't elect out of portability**



**Effect: the deceased spouse's unused applicable exclusion amount (estate exemption) is transferred to his/her surviving spouse.**

# Portability Elections after 706 Due Date

Rev. Proc 2022-32

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- In general, a portability election must be made on a **timely filed** estate tax return (including extensions).
- Exception: a portability election can be made on a 706 filed after the due date and still be considered timely for purposes of the portability election if the following requirements are met:
  - ✓ The decedent was survived by a spouse;
  - ✓ The decedent died after December 31, 2010;
  - ✓ The decedent was a U.S. citizen or resident on the date of death;
  - ✓ The executor was not required to file an estate tax return based on the value of the decedent's estate and lifetime gifts;
  - ✓ The executor did not timely file an estate tax return; and
  - ✓ The executor files a complete and properly prepared Form 706 on or before the 5<sup>th</sup> anniversary of the decedent's death, with the following heading at the top of page 1: FILED PURSUANT TO REV. PROC 2022-32 TO ELECT PORTABILITY UNDER § 2010(c)(5)(A).

# Example

- H dies in 2018 survived by W.
- H's only asset is a \$5 million investment account, which he leaves in a QTIP-able trust for W.
- H made \$3.18 million of lifetime gifts, so his unused applicable exclusion amount was \$8 million.
- H's executor and family, wanting to conserve resources, choose not to file a Form 706 for H since he is under the reporting threshold (\$11.18 million).
- W dies in 2022. Assume:
  - W's adjusted gross estate is \$10 million (excluding the Trust with a date of death value of \$6 million).
  - W's remaining applicable exclusion amount is \$9 million.
  - Result: on W's date of death W owes \$400,000 of federal estate tax.

# Strategic planning

In this scenario, W's executor might consider using Rev. Proc. 2022-32 to file a complete and properly prepared Form 706 for H on or before the fifth anniversary of H's death to both:

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**Port H's unused applicable exclusion amount of \$8 million, thereby eliminating any estate tax liability at W's death, and**

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**Make a QTIP election for the Marital Trust, thereby achieving a basis adjustment for the Marital Trust assets at W's death.**

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# Comparing the Numbers

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	No portability	With Portability
<b>W's Tentative Taxable Estate</b>	\$10 million	\$10 million
<b>W's Adjusted Taxable Gifts</b>	\$3.06 million	\$3.06 million
<b>Marital Trust</b>	N/A	\$6 million
<b>W's Adjusted Taxable Estate</b>	\$13.06 million	\$19.06 million
<b>W's Basic Exclusion Amount</b>	\$12.06 million	\$12.06 million
<b>Deceased Spousal Unused Exclusion Amount</b>	\$0	\$8 million
<b>W's Applicable Exclusion Amount</b>	\$12.06 million	\$20.06 million
<b>W's Taxable Estate</b>	\$1 million	\$0
<b>W's Estate Tax Liability</b>	\$400,000	\$0



# What is the risk of employing this strategy?

If the IRS later determines that a H was over the filing threshold, then

- A late portability election would not be permitted, so the return would not be considered timely for portability purposes;

*But*

- The QTIP election would have been valid, thereby eliminating the use of H's applicable exclusion amount that was associated with the Marital Trust prior to filing the return.

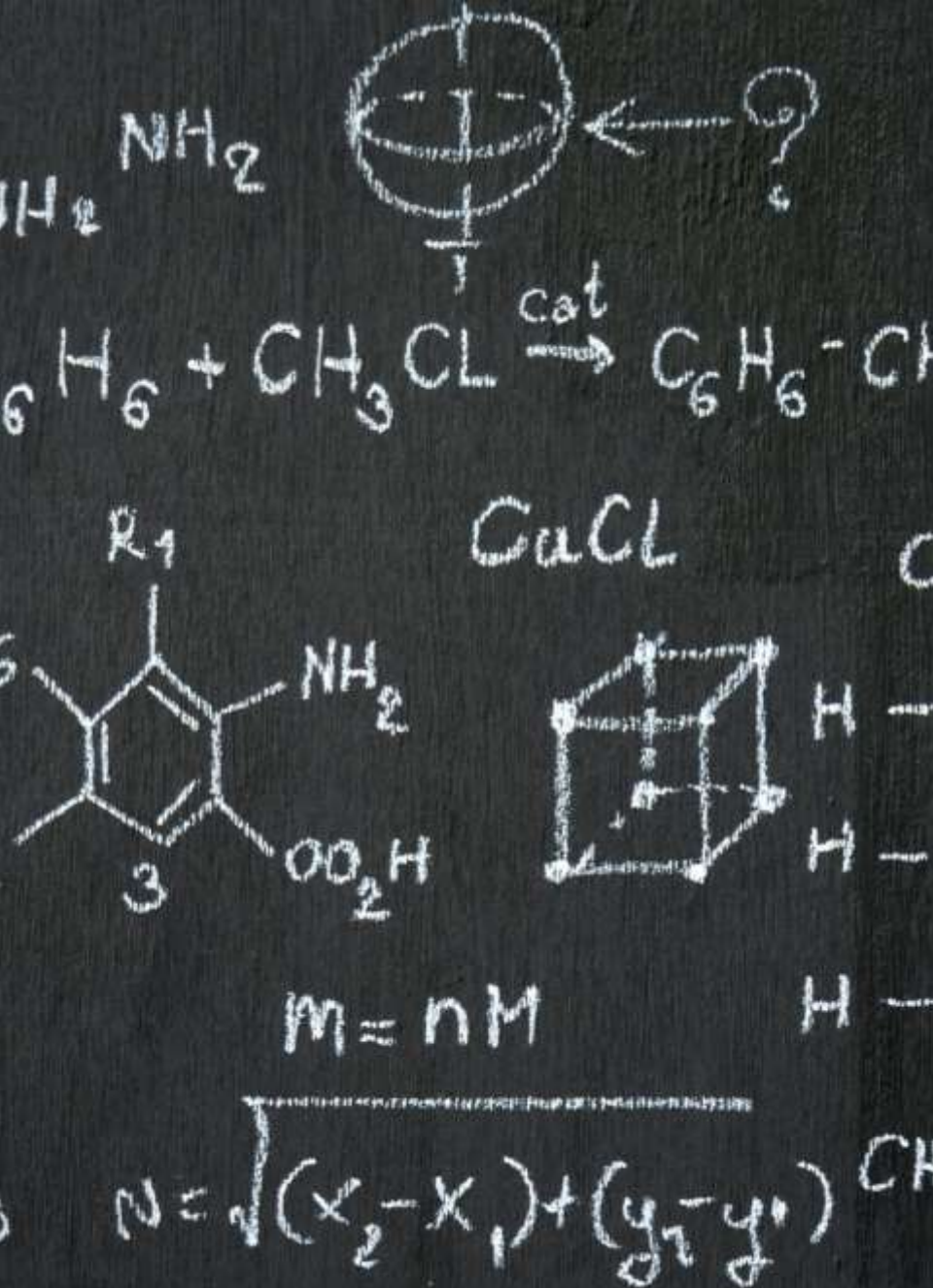
# Limitations

If W died more than 5 years after H, a later filed return cannot take advantage of Rev. Proc. 2022-32 and still be considered timely for portability purposes.

# QTIP Trusts Cannot be Used for Non-Citizen Spouses

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As a general rule, the marital deduction under §2056 is available to a decedent's estate only if the surviving spouse is a U.S. citizen.



# Solution: Use a “QDOT” A Qualified Domestic Trust

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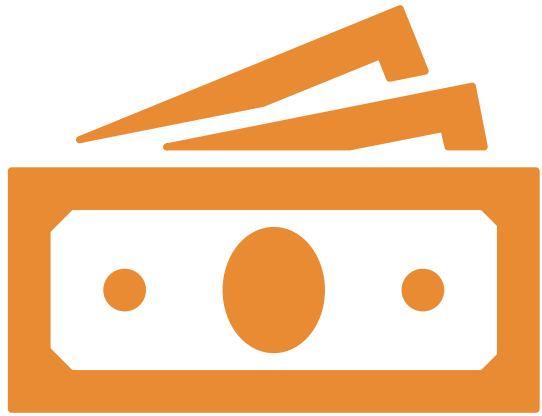
A QDOT is an extension of the marital deductions allowed in Code § 2056(b)(5), (7) or (8).

The foundation for a QDOT can be to a QTIP trust qualifying for the marital deduction under Code § 2056(b)(7), with the addition of a number of governing instrument requirements set forth in Code § 2056A

# QDOT: Governing Instrument Requirements

Must mandate that at least one trustee will be a U.S. citizen or domestic corporation (a “U.S. Trustee”).

Distributions cannot be made unless the U.S. Trustee has the right to withhold estate tax on that distribution.



Additional Security  
Requirement if your  
QDOT is *over* \$2  
million

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## The Security Requirement

:  
QDOTs  
*over*  
\$2 million

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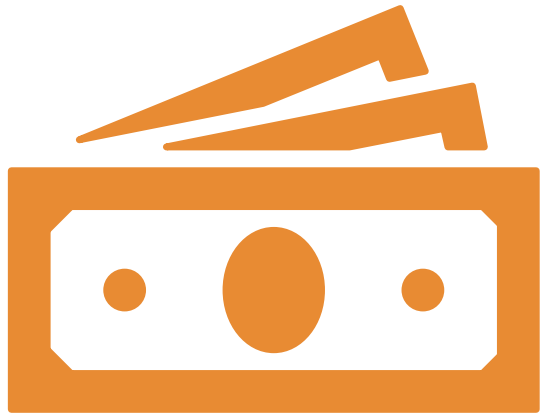
At least one U.S. Trustee must be a Section 581 Bank

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The U.S. Trustee may provide a bond equal to 65% of the fair market value of the trust assets as of DOD

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The U.S. Trustee may furnish an irrevocable letter of credit issued by a Section 581 bank for an amount equal to 65% of the fair market value of the trust assets as of DOD



Additional Security  
Requirement if your  
QDOT is *under* \$2  
million

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The Security  
Requirement  
:  
QDOTs  
*under \$*  
2 million

If a QDOT is under \$2 million, then it must either:

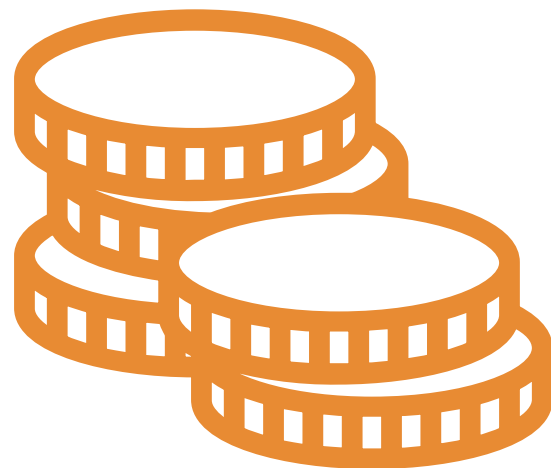
Ensure that no more than 35% of the fair market value of the trust assets, determined annually on the last day of the taxable year will consist of real property located outside of the U.S.

*OR*

Comply with one of the Security Requirements applicable to a QDOT over \$2 million.

# Determining the value of a QDOT

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For purposes of determining whether a QDOT's assets meet the \$2 million threshold to mandate a Security Requirement, the assets are valued:

**as of decedent's date of death,**

*and*

**without regard to any indebtedness on the assets**

*and*

**may exclude up to \$600,000 of the fair market value of any principal residence held by the QDOT for the surviving spouse.**

# Time and Manner of Making the QDOT Election

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- ✓ Must be made on the last federal estate tax return filed before the due date (including extensions) of the decedent's estate tax return.
- ✓ If a timely return is not filed, on the first estate tax return filed after the due date.
- ✓ The election is irrevocable.
- ✓ Election made by listing the QDOT or the trust property and its value on Schedule M.
- ✓ Also required to include an attachment to the estate tax return disclosing:
  - Name and address of every trustee
  - Description of each transfer passing from the decedent to the QDOT
  - The QDOT's EIN

# Protective Elections for QDOTs

Permitted if:

- ❑ bona fide issue concerning the residency or citizenship of the decedent
- ❑ the citizenship of the surviving spouse,
- ❑ whether an asset is includible in the decedent's gross estate, or
- ❑ the amount or nature of the property the surviving spouse is entitled to receive

Partial QDOT  
Elections are  
*not* permitted

A QUALIFIED  
SEVERANCE,  
COMPLETED  
PRIOR TO THE  
DUE DATE WOULD  
BE NECESSARY  
TO ACCOMPLISH  
THIS GOAL.

# Can I fix my QDOT?

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Post-Mortem  
QDOT  
Planning

# How to “Fix” a Bequest to a Non-Citizen Spouse:

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A **trust** for non-Citizen Spouse can be modified into a QDOT, if the governing instrument or local law allows modifications. Modification must be completed on prior to the due date of the decedent’s estate tax return (with extensions), except judicial modifications, which must be filed before the due date.

An **outright bequest** to a non-citizen spouse can be fixed if the surviving spouse actually transfers or irrevocably assigns the property to a QDOT before the return is filed, when can be no later than the due date of the decedent’s estate tax return (with extensions).



# Caution

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If the surviving spouse creates the trust, care should be taken not to create a trust that qualifies as a completed gift by the surviving spouse.



# Taxation of Lifetime Distributions

## Treas. Regs. 20.2056A-5

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- ❖ Distributions of principal (not income) are subject to estate tax based on the value at the time of distribution and the rates in effect at the decedent's death.
- ❖ Hardship exception: distributions for the surviving spouse's health, support, maintenance or education of the surviving spouse or any person the surviving spouse is legally obligated to support.
  - ❖ Financial need must be immediate and substantial.
  - ❖ Not permitted if the surviving spouse has other sources that are reasonably available.
  - ❖ "Reasonably available sources" exclude interests in closely-held business, real estate and tangible personal property.
  - ❖ Must be reported on Form 706-QDT.

# Taxation of Residue at Death of Surviving Spouse

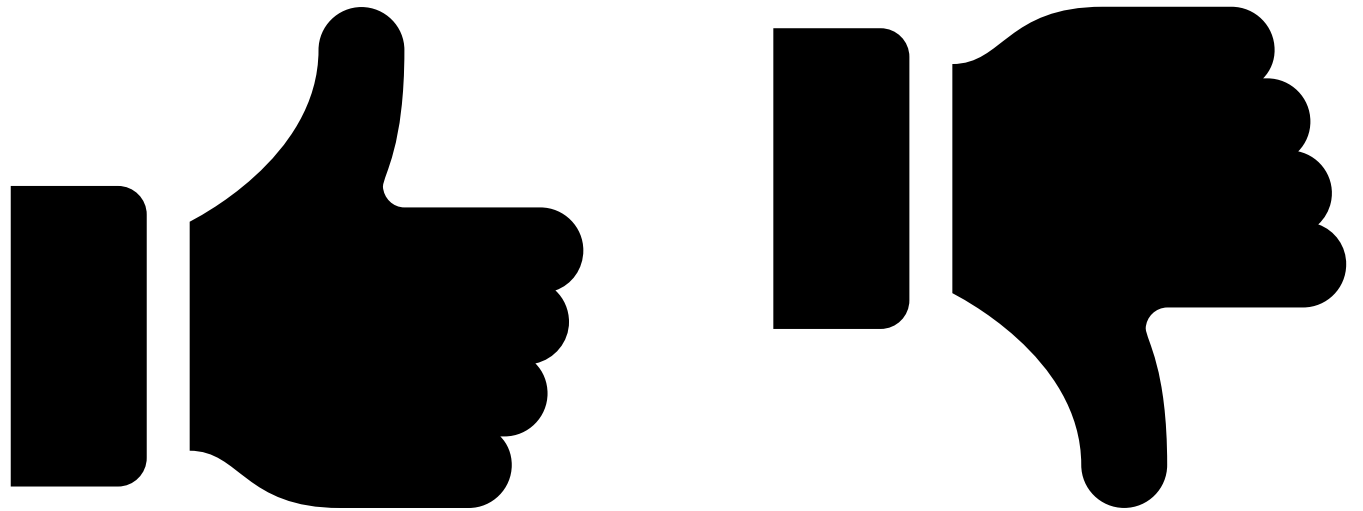
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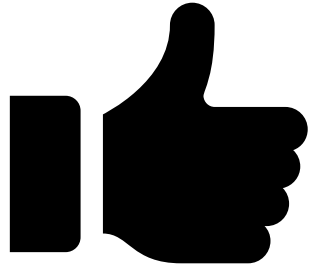
Balance remaining at surviving spouse's death is taxed as though it was included in the estate of predeceased spouse.

If both QTIP and QDOT elections were made, then the balance is also included in the surviving spouse's gross estate under Code Section 2044, and the surviving spouse's estate will receive a credit for the tax imposed on the QDOT assets (up to the tax imposed on the QDOT assets in the surviving spouse's estate).

So are  
QTIPs and  
QDOTs  
worth all the  
trouble?

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# Advantages of Using a QTIP

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Allows the decedent to provide for the surviving spouse while still:

1. Providing financial management assistance to the surviving spouse
2. Limiting use of principal by the surviving spouse
3. Protecting the assets from the surviving spouse's creditors
4. Controlling disposition of the remainder
5. Delaying estate tax until the surviving spouse's death
6. Maximizing use of the couple's GST exemptions



# Disadvantages of Using a QTIP

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1. Additional complexity
2. Additional tax reporting obligations
3. Lack of control by surviving spouse
4. Lack of flexibility for surviving spouse's own estate and gift planning