The QTIP Trust Trap- IRC 2519

Take-Away: While a QTIP Trust is a great way to defer incurring federal estate taxes until the surviving spouse dies, that device is also highly limiting in how the surviving spouse can plan his/her own estate when the QTIP Trust assets will be included in the survivor's taxable estate.

Background: Many wealthy married couples rely on the unlimited marital deduction to *defer* the payment of federal estate taxes on the death of one spouse. The use of the unlimited marital deduction may become even more prevalent for modestly wealthy married couples if/when the applicable exemption amount is reduced by 50% starting in 2026 (unless Congress decides to extend the currently large exemption amounts.) Practically speaking, use of the unlimited marital deduction delays the payment of federal estate taxes since it treats the surviving spouse as the owner of the transferred assets, so that those assets will be included, later, in the surviving spouse taxable estate later. That is the case even if the deceased spouse's assets are transferred to an irrevocable Trust of which the surviving spouse is the lifetime beneficiary- the surviving spouse beneficiary will nonetheless be treated as the *owner* of the QTIP Trust's assets on his/her subsequent death.

Marital Deduction Rules: If a Trust is used and a marital deduction election is timely made, that election requires that *all* income must be paid to the spouse-beneficiary and that the spouse-beneficiary must be the only beneficiary who can receive benefits from the Trust during that spouse's lifetime. The surviving spouse must also be given the authority to compel the trustee to make the QTIP Trust assets income-producing.

Trust *Accounting* Income: The Tax Code is interpreted to require only the payment to the spouse-beneficiary of *ordinary* income items, like dividends, interest, and royalties that the QTIP Trust receives, and not capital gains that result from the appreciation of the Trust's principal. However, there is nothing to prevent the QTIP Trust instrument from being required to pay-out capital gain-type income to the surviving spouse. [IRC 2056(b)(5)(7).] The interpretation of IRC 2056(b)(7), for a qualified terminal interest property Trust, or QTIP Trust, mandates only the payment of trust *accounting income*, not the payment of taxable income to the surviving spouse. Trust *accounting income* usually does *not* include capital gains unless the Trust instrument expressly requires otherwise. Accordingly, most QTIP Trusts provide that interest, dividends, royalties, distributions from entities like LLCs, and other items allocated to income under state law principles are to be transferred at least annually to the surviving spouse, but that capital gains income is retained in the QTIP Trust and that the QTIP Trust pays the capital gains income tax from trust corpus.

The QTIP Trust *Trap:* To assure that the value of the QTIP Trust assets will be included in the surviving spouse's taxable estate, the Tax Code added a limiting provision at the time the QTIP Trust option was created back in 1981. IRC 2519 was enacted along with IRC 2056(b)(7) to prevent the surviving spouse from transferring his/her income interest in the QTIP Trust in a manner that would escape the federal gift and estate tax regime. That Tax Code section, [IRC 2519] entitled Dispositions of Certain Life Estates provides:

(a) General Rule

For purposes of this chapter and chapter 11, any disposition of all or part of a qualifying income interest for life in any property to which this section applies shall be treated as a transfer of <u>*all*</u> *interests in such property other than the qualifying income interest.*

(b) Property to Which This Subsection Applies

This section applies to any property if a deduction was allowed with respect to the transfer of such property to the donor-

(1) Under section 2056 by reason of subsection (b)(7) thereof, or [QTIP marital deduction at death]

(2) Under section 2523 by reason of subjection (f) thereof. [QTIP marital deduction for lifetime gift]

(c)For right of recovery for gift tax in the case of property treated as transferred under this section, see 2207A(b).

Deemed Gift: The result of this rule is that any release or permitted transfer of QTIP Trust assets to a person or persons other than the spouse-beneficiary during that spouse's lifetime can cause the spouse-beneficiary being considered as having made a deemed gift equal in value to the total value of all assets held in the QTIP Trust, even though the value of the gift may be much smaller than this.

Example: Rob created a QTIP Trust for Laura his wife on Rob's death. That QTIP Trust holds $3.0 million in assets. Laura makes a gift of 1% of her income interest to her son Richie. Laura's gift of 1% of her 100% income interest in the QTIP Trust to Richie will cause Laura to be treated as having made a $3.0 million gift. Paying a gift tax on a $3.0 million transfer may come as a big surprise to Laura,

especially if Laura has fully used her available applicable exemption amount. Moreover, since the deemed gift is during Laura's lifetime, the deemed taxable gift of the QTIP Trust's assets will cause those assets to have carry-over basis for Richie, thus forfeiting the opportunity to claim a step-up in income tax basis of the deemed-gift assets on Laura's subsequent death. If Laura considers herself to have sufficient assets in her own name to maintain her lifestyle, any gift of any of one of the QTIP Trust assets to Richie, like the family cottage held in the QTIP Trust, will also cause *all* of the QTIP Trust assets to be treated as given by her, even those assets that remain held in the name of the QTIP Trust other than the cottage. Consequently, not much estate planning for Laura can be accomplished when she is the beneficiary of a QTIP Trust that holds appreciating assets which will be taxed on Laura's death.

Estate of Kite v. Commissioner, Tax Court Memo 2013-43: This is a well-known Tax Court decision where IRC 2519 reared its ugly head getting every estate planner's attention.

Facts: A QTIP Trust was created for the benefit of Mrs. Kite and the death of her husband. In a series of transactions, the QTIP Trust distributed *all* of its assets to Mrs. Kite, who subsequently sold those asset (after a contribution to a limited partnership) to her children in exchange for a deferred private annuity, under which annuity payments would not begin for ten years. Prior to any distribution from the QTIP Trust to Mrs. Kite, the QTIP Trust assets were contributed to the limited partnership in exchange for promissory notes received by the Trust. The IRS did not claim that this sale of assets by the Trust in exchange for the notes triggered IRC 2519. The notes were then contributed to a partnership followed by the partnership interest distributed to Mrs. Kite. Mrs. Kite then sold the partnership interest in exchange for the deferred annuity from her children. Mrs. Kite died three years later; she did not receive any of the annuity payments from her previous sale of the limited partnership interest.

Tax Court: The court found that Mrs. Kite's sale of the former QTIP Trust assets was a bona fide sale for adequate and full consideration. However, that sale was also held to be part of an integrated transaction that resulted in the *deemed disposition* of Mrs. Kite's qualifying income interest in the QTIP Trust, which then triggered the application of IRC 2519 causing all of the QTIP asset to be a deemed gift by her.

Estate Freeze: The sale of the QTIP Trust's appreciating assets in exchange for a note froze the value of the QTIP Trust, similar to an installment sale to a *defective* grantor trust (IDGT) which did not trigger the application of IRC 2519, as the note would simply be a replacement of the QTIP Trust assets in which Mrs. Kite continued to have a qualifying income interest for life.

IRC 2519: In a follow-up trial to determine the value of the gift that resulted from the *deemed disposition* of Mrs. Kite's qualified income interest under IRC 2519, the court held that the deemed transfer of the QTIP remainder interest was a gift of the full remainder interest in the QTIP Trust, regardless of any consideration that was received by Mrs. Kite. This resulted in a significant taxable gift by her.

Fiduciary Implications: The trustee of the QTIP Trust usually has a duty of loyalty and impartiality to *all* trust beneficiaries. Assume that a QTIP Trust created for a surviving spouse also gives to the trustee of the QTIP Trust the discretion to invade trust principal for the surviving spouse's health, education, maintenance, and support, taking into consideration any other financial resources then available to the surviving spouse. The remainder beneficiaries may not be pleased if the trustee invades principal to meet the surviving spouse's request for additional principal distributions. And even if the remainder beneficiaries' consent to the trustee's invasion of a large portion of the QTIP Trust's principal which is paid to or for the benefit of the spouse-beneficiary, an unborn remainder beneficiary might later complain that the principal distribution was not authorized if it went beyond the surviving spouse's health, support or maintenance needs. Moreover, even if the QTIP Trust's remainder beneficiaries' consent to a principal distribution to the surviving spouse from the QTIP Trust, the remainder beneficiaries may be viewed by the IRS as making a taxable gift to the surviving spouse.

Conclusion: A QTIP Trust that holds appreciating assets can assure the surviving spouse that those assets will receive an income tax basis adjustment at his/her subsequent death, since the QTIP Trust asset values will be included in the surviving spouse's taxable estate. The bad news is that those QTIP Trust assets will be exposed to federal estate taxes, when the surviving spouse's applicable exemption amount is scheduled to be cut in half. Any other planning that the surviving spouse may want to engage in using QTIP Trust assets, like sales to IDGTs, transfers to GRATs, gifts to charitable lead annuity trusts (CLAT), or even a QPRT are frustrated by the QTIP Trust 'wrapper' since all those planning strategies are prohibited or are not possible and do not work well due to triggering income tax recognition events, or the deemed gift of the entire QTIP Trust corpus caused by IRC 2519.