

QTIP Trust Flexibility

Take-Away: Because of the restrictive rules associated with a QTIP trust, it is difficult for the surviving spouse-beneficiary to plan for his/her own estate, considering the value of the trust assets will be included in his/her gross estate. With that observation, more thought needs to be given to the terms of the QTIP trust to enable the surviving spouse to plan his/her own estate, such as by providing distributions of trust principal to the surviving spouse to enable him/her to make lifetime gifts.

Background: Over the last several years a lot has been written about spousal lifetime access trusts, or SLATs, as an estate planning device to provide for a spouse, while using the settlor's applicable exemption amount. Much less has been written about qualified terminal interest trusts, or QTIP trusts, which are not taxable gifts but transfer tax deferral devices. Many funded QTIP trust are in existence, but they are fairly inflexible when it comes to enabling the surviving spouse, who is the QTIP trust beneficiary, from planning his/her own estate, considering the QTIP trust assets will be included in the surviving spouse's gross estate at death. Perhaps the terms of a QTIP trust need to be reconsidered to provide additional flexibility to the surviving spouse.

QTIP Trust Rules: For a QTIP trust to be qualified and to defer any federal transfer taxes until the surviving spouse dies, there are three basic rules that must be satisfied: (i) the surviving spouse (trust beneficiary) must have a qualifying income interest for his or her lifetime, which is normally a mandatory right to receive all trust income annually or on a more frequent basis; (ii) no person can be permitted to appoint trust assets to anyone other than the surviving spouse; and (iii) a QTIP election must be made on the decedent spouse's federal estate tax return.

QTIP Tax Rules: Several unique Tax Code rules apply to a QTIP trust.

Estate Inclusion- IRC 2044: As noted earlier, the value of the QTIP trust assets will be included in the surviving spouse's gross estate at his/her death. [IRC 2044; IRC 2056(b)(7).] Thus, estate taxes will have to be paid from the trust before any remaining assets can be distributed to the QTIP trust's remainder beneficiaries. As such, the effect of a QTIP trust is

not to avoid federal estate taxes, but only to defer that tax liability until the surviving spouse's death. This deferral of the estate tax liability could dramatically increase the value of the trust assets included in the gross estate on the surviving spouse's death due to how long the survivor lives, the investment performance of the trust assets, and how little is distributed to meet the survivor's needs or consumption.

Gift Tax Trap- IRC 2519(a): This Tax Code section provides that if the surviving spouse during his/her lifetime disposes of all, or any part of his/her qualifying income interest in the trust, the surviving spouse will be treated as having transferred *all* (not just a part) of the QTIP trust assets, other than the qualifying income interest. Restated, if the surviving spouse transfers any of his/her qualifying income interest, he/she will be treated as having made a taxable gift of the qualifying income interest [IRC 2011] and the value of the QTIP trust assets less the value of the qualifying income interest. [IRC 2519.] Thus, for the surviving spouse to plan for his/her own estate, these rules are a stark impediment to making lifetime gifts.

Tax Court Decisions: Over the past couple of decades, the U.S. Tax Court has had the opportunity to address efforts by a surviving spouse to implement his/her own estate plan utilizing QTIP trust assets with limited success. Three court decisions reflect some of the challenges in planning with QTIP trust assets (most often efforts made to remove appreciated trust assets from the survivor's gross estate.

Estate of Kite v. Commissioner (2013): Over a period of just a month, the mother appointed her children as QTIP trustees, who then terminated the QTIP trust, and 'retroactively' distributed the trust's interest in a family partnership to her. A separate trust for the children then invested in the family partnership taking a controlling interest. The mother then sold her remaining interest in the family partnership to her children in exchange for unsecured private 10-year deferred annuities having a fair market value equal to the discounted value of her partnership interest. The mother died without ever receiving an annuity payment.

The Tax Court found that all these separate steps were an integrated single transaction and treated it as if the QTIP trust had sold its assets in exchange for the deferred private annuities. Despite it being a sale for consideration, the court found that the sale

extinguished the mother's income interest, thus triggering IRC 2519. In a subsequent court order the Tax Court then held that the termination of the QTIP trust alone in favor of the mother could result in the transfer of her qualifying income interest triggering a gift under IRC 2519, implying that any distribution of QTIP trust principal to her constitutes a disposition of the qualifying income interest leading to a taxable gift equal to the actuarial value of the remainder interest in the distributed trust assets!

Estate of Annenberg v. Commissioner (2024): The mother and the trust's remainder beneficiaries, her sons, entered into a judicial settlement to terminate the QTIP trust and distribute its assets (closely held stock) to the mother. All trust assets, i.e., the stock, was then distributed to her, thus terminating the QTIP trust. Five months later the mother gifted some her stock to her sons. A month later she then sold all of her remaining stock to her sons in exchange for 9-year promissory notes. These notes were secured by the stock that she sold, along with limited personal guarantees of her sons. The IRS claimed that IRC 2519 applied.

The Tax Court held that the transfer of stock alone resulting from the termination of the QTIP trust in favor of the mother was not enough to trigger a gift tax under IRC 2519. There was no 'gratuitous transfer' according to the Court for a gift to have occurred. The Court then found that the subsequent sale of the shares did not implicate IRC 2519 since the QTIP trust no longer existed. The Court then distinguished the result from the *Kite* decisions noting that it had applied the substance-over-form doctrine to find that the separate transactions were part of an integrated transaction that 'was designed to circumvent the QTIP regime' while in *Annenberg*, the Court had not been asked by the IRS to apply the substance-over-form doctrine, primarily because of the 5 months between the separate transactions. The Court also noted, in passing, that the residual value of the QTIP trust assets (in the form of the arm's-length promissory notes, were still part of the mother's taxable estate.

McDougall v. Commissioner (2024): The wife died in 2011 creating a QTIP trust for her husband. The QTIP trust required the trustee to distribute all trust income to the husband, at least annually. The trust also gave the trustee the discretion to distribute trust principal to or for the benefit of the husband following a HEMS distribution standard and in support of his accustomed manner of living. In addition, the trust also gave the husband a testamentary limited power to appoint principal to or among his wife's descendants. Five

years after the QTIP trust was created the husband and the QTIP trust remainder beneficiaries entered into a nonjudicial settlement agreement. That agreement terminated the QTIP trust and directed that all of its assets be distributed to the husband. On the same day, the trust was terminated the husband sold the trust assets to trusts established for the remainder beneficiaries in exchange for promissory notes. The IRS contended that the transaction triggered IRC 2519 and in addition, that the remainder beneficiaries made taxable gifts equal to the value of their remainder interests in the QTIP trust to the husband by their consent to the termination of the trust.

The Court found that the sale of the QTIP assets by the husband did not involve IRC 2519, consistent with its *Anenberg* decision. However, the Court found that the remainder beneficiaries had made gifts to the husband, since they had received no consideration when they consented to the termination of the trust, thus causing gift taxation under IRC 251.

The upshot of the *Anenberg* and *McDougall* decisions is that neither distributions nor terminations of a QTIP trust to the surviving spouse beneficiary will implicate IRC 2519, but the involvement of the QTIP remainder beneficiaries in the termination of the QTIP trust will cause them to deal with gift tax liability.

Planning Implications: These Tax Court decisions provide some ideas on what planning a surviving spouse who is the beneficiary of a QTIP trust might take.

1. The distribution of QTIP trust assets to the surviving spouse will not result in a taxable gift by the surviving spouse, even if the QTIP trust is terminated.
2. If the QTIP trust instrument permits discretionary distributions of trust principal to the surviving spouse, then those discretionary distributions of principal will not carry gift tax implications. Accordingly, a discretionary principal distribution standard used in the QTIP trust might go beyond 'health, education, support, and maintenance' to include 'distributions to enable the lifetime trust beneficiary to engage in tax planning free from the constraints of the QTIP rules.'

3. The QTIP trust instrument might provide to the surviving spouse, dependent on some circumstances as determined by the trustee, to possess a five + five withdrawal power, which could then be used to enable the survivor to make annual exclusion gifts.

4. The trust instrument must avoid any planning step that involves the trust remainder beneficiaries or their consent. The trust instrument might provide for modifications or amendment without the involvement of the trust remainder beneficiaries. For example, if the QTIP trust is to be decanted to add more flexibility to its terms, and the remainder beneficiaries are required by state law to be given notice of the trustee's intent to decant, then that notice requirement might be enough cause those beneficiaries gift tax exposure if they do not object to the proposed decanting. This concern might warrant the QTIP trust instrument to have its own decanting rules which avoid the use state decanting statutes and procedures that require some notice, or consent, by the remainder trust beneficiaries.

Conclusion: While a QTIP trust defers federal estate taxes, there will some day in the future be the occasion when those deferred estate taxes will have to be paid. About the only side-benefit to this will be a step-up in the QTIP trust assets on the surviving spouse's death. [IRC 1014.] That said, no one really knows what the tax rules will be far into the future, and a surviving spouse may want to engage in some estate 'freeze' strategies to minimize the federal estate tax liability that the QTIP trust presents. Building flexibility into the QTIP trust instrument might go a long way to enable the survivor to better plan his/her own estate.

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