



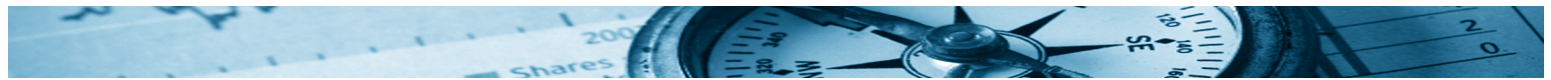
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Qualified Terminable Interest Property (QTIP) Trust (also called C Trust)





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What is a qualified terminable interest property (QTIP) trust?

A QTIP trust is a type of marital trust

A qualified terminable interest property (QTIP) trust is a type of marital trust used most often with a to maximize the use of both spouses' applicable exclusion amounts (the amount that can be sheltered from federal gift and estate tax by the unified credit). Perhaps more importantly, the first spouse to die can specify in the trust instrument to whom the assets in the trust will pass at the death of the surviving spouse.

Typically, a married couple with substantial assets will each set up a bypass and a QTIP marital trust either in their individual wills or in separate inter vivos documents. At the death of the first spouse, enough assets will be transferred from his or her estate to his or her bypass trust to more fully make use of his or her applicable exclusion amount. The remaining assets of the first spouse to die will fund his or her marital trust.

Tip: *In 2011 and later years, the unused basic exclusion of a deceased spouse is portable and may allow you and your spouse to take full advantage of the estate tax applicable exclusion amount without using a bypass trust.*

The surviving spouse must receive all income generated by the QTIP trust for his or her lifetime. However, the surviving spouse generally will not have the right to access principal during his or her lifetime or to designate to whom the principal will go when he or she dies. The first spouse to die can specify in the QTIP trust instrument where the principal should pass at the death of the surviving spouse.

A QTIP trust is a statutory exception to the terminable interest rule

The exception to the terminable interest rule permitting a QTIP trust to qualify for the unlimited marital deduction was added to the Internal Revenue Code by the Economic Recovery Tax Act of 1981 (ERTA). Prior to ERTA, only three types of transfers from one spouse to another spouse qualified for the unlimited marital deduction. (The unlimited marital deduction allows one spouse to leave an unlimited amount of assets to the surviving spouse without potentially incurring estate taxes on those assets. Of course, when the surviving spouse dies, those assets will be includable in his or her estate for estate tax purposes.) First, an outright transfer to the surviving spouse by either will or operation of law (as with joint ownership) qualified for the unlimited marital deduction. Second, property transferred to the surviving spouse as a beneficiary of an insurance policy or a pension plan qualified for the unlimited marital deduction. Third, a transfer to the surviving spouse in the traditional marital trust where he or she has a life estate and a general power of appointment over the assets in the trust qualified for the unlimited marital deduction. A general power of appointment permits the powerholder to use the assets in the trust for his or her benefit during his or her lifetime or to appoint the assets to anyone including his or her estate, his or her creditors, or the creditors of his or her estate, when he or she dies.

The terminable interest rule operates to disqualify life estates and other terminable interests that benefit a surviving spouse from receiving the benefits of the unlimited marital deduction. A terminable interest is an interest that terminates or fails on the lapse of time, on the occurrence of an event or contingency, or on the failure of an event or contingency to occur. With the passage of ERTA in 1981, Congress created an exception to this general rule for the QTIP trust. With a QTIP trust, the surviving spouse has a terminable interest in the trust (i.e., the spouse's interest in the trust is a life interest which ends when he or she dies), which, before ERTA, would not have qualified for the unlimited marital deduction. However, with the passage of ERTA, the assets passing to the surviving spouse in the QTIP trust will qualify for the unlimited marital deduction. The assets in the QTIP trust will be includable in the estate of the surviving spouse for estate tax purposes. However, he or she can then use his or her applicable exclusion amount to protect some or all of the assets in the trust from federal estate tax. The advantage a QTIP trust offers over other methods of passing property on to the surviving spouse is that it permits the grantor to designate to whom the assets will pass at the death of the surviving spouse.

Tip: *With a power of appointment marital trust, the surviving spouse generally has considerably more control over the trust assets than with a QTIP trust.*

How are QTIP trusts governed?

A trust must satisfy four technical requirements to receive QTIP treatment under IRS rules and regulations.

Property must pass from a decedent spouse to the surviving spouse

Usually, the transfer of property to the surviving spouse via the QTIP trust occurs upon the death of the first spouse to die, and the executor is authorized in the decedent's will to make the transfer of assets from the estate of the decedent to the QTIP trust. However, an individual can also set up a QTIP trust and make transfers to the trust during his or her lifetime. A transfer to a QTIP



trust can be a direct transfer of assets, receipt of the proceeds from a life insurance policy, or the death proceeds from a qualified or nonqualified pension plan — all such transfers are deemed to have "passed" from the decedent.

The surviving spouse must receive all income from the QTIP trust for life

The surviving spouse must receive all income from the QTIP trust for his or her lifetime, and the income must be paid to the spouse at least annually. Furthermore, the surviving spouse must be given the power to force the trustee to make the assets in the trust income-producing. Therefore, if you transfer growth stocks that do not yield any income to the QTIP trust, your surviving spouse can force the trustee to sell the growth stocks and invest in income-producing assets.

This requirement can pose a problem if, for example, you transfer stock in your closely held company to the trust. If the stock does not pay any dividends, and the surviving spouse forces the trustee to sell the closely held stock, the trustee may have a very hard time finding a buyer for the stock. The sale of the closely held stock may also disrupt the ongoing operation of the company as a family business. There are ways to design an estate plan around this problem, but you will need the advice of an estate planning attorney.

No one (including the surviving spouse) can be given power to direct that trust property go to anyone but the surviving spouse during the surviving spouse's lifetime

With a QTIP trust, no one (including the surviving spouse) may be given the power to appoint trust property to anyone as long as the surviving spouse is alive. Therefore, the trustee of the trust cannot be given the power to transfer trust property to your children as long as the surviving spouse is alive. Another person (i.e., a beneficiary or trustee of the trust) may be given the power to appoint the assets in the QTIP trust to someone other than the surviving spouse, if that power can only be exercised after the surviving spouse has died. The surviving spouse may be given the power to appoint the trust property to himself or herself during his or her lifetime — the fact that he or she can transfer property distributed to him or her to third parties does not disqualify the trust as long as he or she is not legally bound to do so. The surviving spouse can also be given a general or limited testamentary power (i.e., exercisable in his or her will) to appoint assets in the trust. You may want to give your surviving spouse this power if you think, for example, that some of your children may need more assets than others. It may be impossible to determine who will ultimately need the assets until well after your death. However, the surviving spouse cannot be given a limited power of appointment (e.g., exercisable in favor of certain individuals other than the surviving spouse) exercisable during her lifetime.

The executor for the estate of the first spouse to die must make an irrevocable QTIP election

In order to qualify the trust assets for the unlimited marital deduction, the executor must make a timely and irrevocable QTIP election on the estate tax return of the first spouse to die. By making a QTIP election, the surviving spouse agrees that the property remaining in the trust on his or her death will be includable in his or her estate for estate tax purposes. If you transfer property to a QTIP trust during your lifetime, you must make a similar election on the federal gift tax return.

Why use a QTIP trust?

The first spouse to die may dictate in the QTIP trust instrument to whom assets will go at the death of the surviving spouse

A principal benefit of using a QTIP trust is that the first spouse to die may specify in the trust instrument to whom the assets in the QTIP trust will pass at the death of the surviving spouse. A QTIP trust is especially useful if you have children from either your first or second marriage and you would like those kids to eventually inherit your assets. If you simply left your assets to your spouse, he or she might remarry and leave your assets to the new spouse or to his or her own relatives. The surviving spouse might also consume or squander the assets, leaving your children high and dry.

Example(s): Say you and your wife have accumulated substantial assets. You have three children from the marriage, and both you and your spouse would like your three children to eventually inherit all of your assets. Your estate planning attorney suggests setting up both a bypass and QTIP marital trust. Your attorney also suggests that you and your spouse divide up the ownership of your assets. In your will, you give your executor the authority to transfer enough assets to the bypass trust at your death to more fully use the applicable exclusion amount. Your executor is then given the authority to transfer your remaining assets to a QTIP trust. Your surviving spouse must receive all the income for life from the QTIP trust. However, you can designate in the QTIP trust instrument that at the death of your surviving spouse, all of your assets should be divided equally among your three children.

A QTIP trust may allow both spouses to more fully make use of their applicable exclusion amounts

One of the reasons to set up a QTIP trust is to maximize the applicable exclusion amounts of both spouses. Usually, a married couple with substantial assets will set up both a bypass and a QTIP trust. Enough assets from the estate of the first spouse to die will be transferred into the bypass trust to completely use his or her applicable exclusion amount (\$12,060,000 in 2022, \$11,700,000 in 2021). The remainder of the assets of the first spouse to die will then be transferred to the QTIP trust. These assets will be includable in the estate of the surviving spouse for estate tax purposes, but he or she can then use the applicable exclusion amount to protect some or all of these assets from federal estate taxes. By using the two trusts, a married couple can maximize the amount of assets that can be passed on to their beneficiaries free from federal estate taxes.

Caution: This may not be the proper strategy for some married couples. A tax law passed in 2001 replaced the state death credit



with a deduction starting in 2005. As a result, many of the states that imposed a death tax equal to the credit, decoupled their tax systems, imposing a stand-alone death tax. Many of these states allow an exemption that is less than the federal exemption. This may leave some couples vulnerable to higher state death taxation. See your financial professional for more information.

Tip: In 2011 and later years, the unused basic exclusion of a deceased spouse is portable and may allow you and your spouse to take full advantage of the estate tax applicable exclusion amount without using a bypass trust.

The surviving spouse is assured of receiving all income from the QTIP trust

Another reason to use a QTIP trust is that the surviving spouse must receive all income for life from the trust. Moreover, the surviving spouse must be given the power to force the trustee to make the assets in the trust income-producing. Thus, if the trust holds assets such as growth stocks or undeveloped land, the surviving spouse can force the trustee to sell those assets and reinvest them in income-producing assets.

The surviving spouse may be given other rights in the QTIP trust

Several optional provisions may be included in a QTIP trust. First, you may draft a spendthrift provision for the trust to protect the trust assets against claims of future husbands or wives, or ex-spouses, creditors, or other outsiders trying to get at the assets. Second, the surviving spouse can be made the trustee of the trust as long as the power to distribute assets to himself or herself is limited to health, education, maintenance, or support. Third, an independent trustee can be given the authority to distribute assets, in his or her sole discretion, to the surviving spouse. Finally, the surviving spouse can be given a testamentary power of appointment (i.e., the power to change the beneficiaries by his or her will). The power to change the beneficiaries can be limited to a specific class, such as your children or grandchildren.

Example(s): Say you have set up a QTIP trust to be funded through your will when you die. You have named your three children as the remainder beneficiaries of the trust. Although your intention now is to divide up the assets equally among your children, you would like to give your spouse the flexibility to alter the amount that each one will eventually receive if their needs should change after your death. A provision may be added to the QTIP trust giving the surviving spouse the limited power to alter the beneficiaries by his or her will (within a given class, if so desired).

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