QTIP TRUST

A QTIP trust. What a name. I guess when you have an area as dry as the tax aspects of estate planning, you have to have strange names in order to spice things up. QTIP is the acronym for qualified terminable interest property. That really doesn't help. Okay, how about an overview with some background to put the concept of this type of trust in context, then we will discuss its uses.

The QTIP trust is a trust in which the surviving spouse is the sole beneficiary during his/her lifetime and receives all of the income from the trust for his/her lifetime. A gift to one's spouse in a QTIP trust qualifies as a gift to one's spouse and is considered deductible when determining the estate tax owed on your death. Upon your spouse's death, the trust assets are taxed at your spouse's highest marginal rate. The property remaining in the trust after payment of the estate taxes passes to the person or persons you designated in your Will. In other words, the trust enables you to defer the tax on the property until your spouse's death and still control to whom the trust assets will pass upon your spouse's death. The only requirement is that your spouse receive all of the income from the trust each year.

> ...enables you to defer the tax on the property until your spouse's death and still control to whom the trust assets will pass upon your spouse's death.

I have said it all, so let's just close this chapter right here. Of course, I can't do that because I haven't told you why this trust is so important from an historical perspective. Ho, hum.

Prior to 1981, you could only give your spouse one-half of your separate property tax free. The gift to one's spouse was referred to as the marital deduction, since the amount given to one's spouse (up to one-half of your separate property) was deductible in determining the tax owed on your estate. The purpose of the deduction was to put separate property states on a parity with community property states where the surviving spouse owned one-half of the community. In order to qualify for this deduction, you had to give the property outright to the spouse or place it in a trust in which the spouse's interest did not terminate. The spouse had to have the power to direct the distribution of the property upon his/her death.

> The main requirement is that all of the income be paid to your spouse each year. You cannot provide that your spouse ceases to be a beneficiary of the trust should he/she remarry.

In 1981, the law was changed to allow you to give your spouse your entire estate without tax. Under prior law, in order to qualify for this deduction, you would have had to give your spouse the power to dispose of this property in his/her Will. This requirement created a difficult decision - pay the tax or allow your spouse to cut out your kids (or other intended beneficiaries). So, Congress decided to create a special type of trust in which your spouse's interest did terminate, allowing you to control the distribution of the trust upon your spouse's death. This trust was called the Qualified Terminable Interest Property Trust. Any other marital trust you use requires that the spouse have the power to dispose of the property upon his/her death. As you might guess, the other types of marital trusts are rarely used. The main requirement is that all of the income be paid to your spouse each year. You cannot provide that your spouse ceases to be a beneficiary of the trust should he/she remarry.

> Under prior law, in order to qualify for this deduction, you would have had to give your spouse the power to dispose of this property in his/her Will....created a difficult decision - pay the tax or allow your spouse to cut out your kids

Do you have to leave the property in a QTIP trust in order to get the deduction? No. You can give your estate to your spouse outright. The problem with giving the property to one's spouse outright is that your spouse may give the property to his/her subsequent spouse (I wasn't sure how to say second, third or fourth spouse in a tactful manner) or if you both have been married before, then to her children rather than to your children. So the main benefit of the QTIP trust is control.

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In summary the QTIP trust is:

- A trust for the benefit of the surviving spouse for his/her lifetime.
- The trust must provide that all of the income received by the trust is distributed to the spouse each year. The trust may provide that the spouse can receive the principal of the trust.
- The property is included in the surviving spouse's estate and is taxed upon the surviving spouse's death.
- The property is protected from creditors.
- The main benefit of creating the trust is control -
    - Control over the distribution of the assets during the spouse's life (with the exception of the income), the principal can be restricted or restricted upon the occurrence of certain events (e.g., remarriage)
    - Control over the management of the assets for a spouse who is not capable of managing the

property and/or is not fiscally responsible.

> Control over the distribution of the trust assets upon the death of the surviving spouse.

The benefits of the trust also describe its uses. It is not used to eliminate tax upon your death since an outright gift would do that. It is most frequently used to control the distribution of the assets upon the death of the survivor and, to a lesser extent, to restrict the use of the funds during the survivor's lifetime.

Why are there two QTIP trusts in my plan? You have reviewed your plan and noticed that your plan includes a Bypass Trust, a Marital Deduction Generation Skipping Trust and a Marital Deduction Trust. Both of the Marital Deduction Trusts are QTIP trusts. You will specify how the property in each of these trusts is distributed upon your spouse's death.

Why are there two QTIP trusts in my plan?

Let's back up a bit, and discuss a little of the structure of the generation skipping trusts. A more lengthy discussion of the generation skipping trust is in another chapter, but a brief summary is needed here. Generation skipping trusts do not skip a generation in terms of the benefits provided, but do skip taxation in your children's estate. The trust provides for your children to receive income and principal from the trust, to the extent needed. This type of trust was so beneficial in providing one's children with full benefits from the trust's assets, but was not taxed upon their death, that a new tax was created, enter the generation skipping tax. The generation skipping tax is a tax in addition to the estate or gift tax and is a flat tax at the highest estate tax rate, 49% in 2003. This tax has eliminated the benefits of this type of trust in almost every situation. However, each person has a $1,120,000 exemption from this tax in 2003. Since the trust can be structured to provide benefits for your children, avoid tax, protect the assets from creditors and, to some extent, from estranged spouses, it is very advantageous to use this trust as much as one is able.

Now let's return to the two QTIP trusts in your estate plan.... If you have not used all of your exemption during your lifetime, your plan sets up a Bypass Trust. Part of your $1,120,000 exemption is allocated to this trust. The remaining portion of your $1,120,000 exemption is held in one of the QTIP trusts. For example, let's assume that your Bypass Trust holds $650,000 (since you made gifts using $350,000 during your lifetime). If you have not used any of the generation skipping exemption during your lifetime, then one of the QTIP trusts will hold $470,000 and the remainder of your $1,120,000 generation skipping exemption will be allocated to this trust. This trust is the one which is referred to as the Marital Deduction Generation Skipping Trust.

All the rest of your property (your separate property and your half of the community over $1,120,000) is held in the Marital Deduction Trust.

The terms of each of these Marital Trusts is identical. The only difference between the trusts is that upon your spouse's death, the Marital Deduction Generation Skipping Trust is combined with the Bypass Trust and divided into separate trusts for your children which will continue for their lifetime. The Marital Deduction Trust is distributed to your children outright or to trusts for your children which will be distributed to them at a certain age and/or be taxed in their estate.

Beginning in 2004 the estate tax exemption and the generation skipping tax exemption are identical. Creation of two Marital Trusts will only occur if you use part of your estate tax exemption during your lifetime or, if you die after 2010 and the law has not been changed .... Doesn't the structure of the estate tax law with the sunset provision in 2011 make everything in this area even more confusing?