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## The Qualified Terminable Interest Property Marital Deduction Trust

### §3.1 FOUR BASIC QTIP TRUST REQUIREMENTS

A QTIP bequest is a statutory exception to the definition of “nondeductible terminable interest.” Under this exception, the marital deduction is allowed for property given to a QTIP trust for the benefit the decedent’s surviving spouse if: (1) the surviving spouse has a lifetime right to all of the trust’s income, which must be payable to the surviving spouse annually or more often; (2) no person has a power during the surviving spouse’s life to appoint any part of the property to any person other than to the surviving spouse; (3) the surviving spouse is the sole lifetime beneficiary of the trust; and (4) the decedent’s executor makes an election to treat all or a specific portion of the trust property as qualified terminable interest property. IRC section 2056(b)(7). These requirements for QTIP treatment are in addition to the seven essential requirements for the marital deduction (discussed in section 2.1, above).<sup>1</sup>

### §3.2 INCOME FOR LIFE REQUIREMENT

The surviving spouse must receive all the QTIP trust income for life. IRC section 2056(b)(7)(B)(ii). Depending on state law, “income” may now be defined as a unitrust interest, which is discussed in section 6.2, below.<sup>2</sup>

#### §3.2(a) Income Payable At Least Annually

The income must be payable at least annually. IRC section 2056(b)(7)(B)(ii)(I). *See*, Paragraph 3.6(A) (alternative 1) of Sample MD Trust.

#### §3.2(b) Usufruct

In Louisiana or under foreign law, the spouse has a usufruct interest.

#### §3.2(c) Contingent Income Interest

Under current law, an income interest contingent upon a QTIP election satisfies the income requirement. Treas. Reg. §§20.2056(b)-7(d)(3)(ii); 20.2056(b)-10. *See*, Paragraph 3.5(D) of Sample MD Trust. *See*, section 3.7 below for further discussion of the contingent QTIP election.

#### §3.2(d) Stub Income

Stub income (income accumulated between the last income payment and the surviving spouse’s death) does not have to be distributed to the surviving spouse’s estate. Treas. Reg. §20.2056(b)-7(d)(4). However, the amount of the stub income must be included in the surviving spouse’s gross estate, and will constitute IRC section 691(a) income in respect of a decedent. Treas. Reg. §20.2044-1(d)(2). *See*, Paragraph 5.7 of Sample MD Trust.

**Practice Point:** Stub income not distributed to the surviving spouse’s estate can be subject to a testamentary limited power of appointment exercisable by the surviving spouse.

#### §3.2(e) Use Of Residence

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<sup>1</sup> *See*, Chapter 9 of Antonucci and Whitman, *After Death Tax Planning: Minimizing Tax Liabilities* (ALI-ABA, Philadelphia, 3d ed. 2004), [www.aliaba.org/aliaba/BK32.asp](http://www.aliaba.org/aliaba/BK32.asp), for a summary of QTIP.

<sup>2</sup> *See*, section 6.1, below, for further discussion of the “all income” to surviving spouse requirement.

An exclusive and unrestricted right to use a residence for life qualifies for QTIP treatment. Treas. Reg. §20.2056(b)-7(h), Example 1. *See also*, Pvt. Letter Ruls. 200222024 and 9047051.

### **§3.2(f) IRA Distributions To A QTIP Trust**

IRA distributions can qualify for QTIP treatment if the distributions are to be made to a QTIP trust over the spouse's life; if the annual income from the IRA and from the trust is required to be paid to the surviving spouse at least annually; if both the IRA and marital deduction trust are elected for QTIP treatment; and if the minimum distribution requirements are satisfied. *See*, Rev. Rul. 2000-2, 2001-1 C.B. 305; Rev. Rul. 89-89, 1989-2 C.B. 231. *See also*, Pvt. Letter Ruls. 9830004 and 9442032.<sup>3</sup> *See*, Paragraph 3.6(C) (alternative 1) of Sample MD Trust for a sample IRA conduit trust.

### **§3.2(g) Non-Income-Producing Property**

A trustee may have the power to retain non-income-producing property if the surviving spouse has the power to require conversion of the asset into income-producing property. Treas. Reg. §20.2056(b)-7(d)(2). *See*, Paragraphs 3.6(G) (alternative 1) and 5.1(C)(2) of Sample MD Trust. *See*, section 6.1, below, for further discussion on non-income-producing property and the "all income" to spouse requirement.

## **§3.3 POWER OF APPOINTMENT OVER QTIP TRUST**

There can be no right to appoint the QTIP trust income or principal to anyone else (other than to the surviving spouse) during the surviving spouse's life.

### **§3.3(a) Power To Distribute QTIP Principal To Surviving Spouse**

A trustee can, however, invade principal for the surviving spouse's benefit. Treas. Reg. §20.2056(b)-7(d)(6). *See*, Paragraph 3.6(B) (alternative 1) of Sample MD Trust.

### **§3.3(b) Testamentary Powers Of Appointment**

A testamentary power (preferably a testamentary limited power of appointment) that is exercisable upon the death of the surviving spouse is permitted. IRC section 2056(b)(7)(B)(ii). Granting the surviving spouse a testamentary limited power to appoint the remaining trust property among the deceased grantor's beneficiaries provides for post-mortem tax planning flexibility. The testamentary limited power of appointment allows the surviving spouse to take account of the beneficiaries' circumstances and to optimize allocation of the GST tax exemption. However, granting the surviving spouse a testamentary general power of appointment may cause the marital trust to be included in the surviving spouse's estate under IRC section 2041 (and not IRC section 2044), which could result in the aggregation of the marital trust assets with the spouse's own assets, and preclude a reverse QTIP election. *See, Estate of Aldo H. Fontana v. Commissioner*, 118 T.C. 318 (2002). *See also*, Pvt. Letter Rul. 200024015, where the IRS permitted a QTIP election for a trust that gave the surviving spouse a testamentary general power of appointment. In that letter ruling, the IRS stated that "at Taxpayer's death, the value of the qualified share will be includable in Taxpayer's gross estate under section 2041,

<sup>3</sup> *See*, Appendix 3 for a summary of the final Treasury Regulations concerning required minimum distributions under IRC section 401(a)(9), and the regulations' impact on naming a trust as a beneficiary of an IRA. *See also*, Chapter 11 of Horn, *Flexible Trusts and Estates for Uncertain Times* (ALI-ABA, Philadelphia, 2003), [www.ali-aba.org/aliaba/BK26.asp](http://www.ali-aba.org/aliaba/BK26.asp) (for sample marital deduction trust language); Chapter 13 of John R. Price, *Price on Contemporary Estate Planning* (Aspen Publishers, Inc. New York, 2d ed. 2000 & Supp. 2003); Natalie B. Choate, *Life and Death Planning for Retirement Benefits: The Essential Handbook for Estate Planners* (Ataxplan Publications, Boston, 5th ed. 2003); and Louis A. Mezzullo, 814-2nd T.M., *Estate and Gift Tax Issues for Employee Benefit Plans* (BNA Inc., Washington, DC) for a discussion of IRAs and qualified retirement plan benefits held by a marital deduction trust, along with sample beneficiary designation forms and sample marital deduction trust language.

and Taxpayer will be the transferor of this value for generation-skipping transfer tax purposes.” See, Paragraph 3.6(E)(1) (alternative 1) of Sample MD Trust.

### §3.3(c) Gifts Of Distributed QTIP Trust Property

The surviving spouse can make gifts of principal once the principal has been distributed to the surviving spouse. Treas. Reg. §20.2056(b)-7(d)(6). However, a lifetime power of the surviving spouse to appoint trust property to the decedent’s descendants will prevent the QTIP trust from qualifying for marital deduction. The IRS rejected the argument that a savings provision in the trust negated this impermissible power. Pvt. Letter Rul. 200234017.

### §3.3(d) Distribution Of QTIP Trust Property To Third Party

The ability of the trustee to distribute principal to a third party (in this case the couple’s daughter) with the spouse’s consent will disqualify the trust for marital deduction purposes. *Estate of John D. Manscill v. Commissioner*, 98 T.C. 413 (1992). However, a trustee can be authorized to distribute principal to the surviving spouse to be used by the spouse for care of dependent children, because the spouse is the person controlling disbursement of the distribution. Pvt. Letter Rul. 8526009.

### §3.3(e) Spouse’s Power Of Withdrawal

The surviving spouse can be given an annual power of withdrawal over the QTIP property, where the withdrawal right is limited to \$5,000 or five percent of the trust estate. IRC sections 2514(e) and 2041(b)(2). Although the 5x5 withdrawal right constitutes a general power of appointment under IRC section 2041, the right of withdrawal does not cause the QTIP trust to be classified as an IRC section 2056(b)(5) general power of appointment marital deduction trust. Additionally, the surviving spouse can be given the right to appoint the 5x5 amount to a third party, provided the class of donees includes both the surviving spouse and the third party. Pvt. Letter Rul. 8943005.<sup>4</sup> See, Paragraph 3.6(D) (alternative 1) of Sample MD Trust.<sup>5</sup>

**Practice Point:** An unexercised 5x5 withdrawal right produces capital gains tax complications to the surviving spouse by creating partial grantor trust status of the QTIP trust under IRC section 678(a). This

<sup>4</sup> In permitting the power of withdrawal, which is a general power of appointment, the IRS stated:

“The legislative history underlying section 2056(b)(7) states, in part:

[T]here must be no power in any person (including the spouse) to appoint any part of the property subject to the qualifying income interest to any person other than the spouse during the spouse’s life. This rule will...insure that the value of the property not consumed by the spouse is subject to tax upon the spouse’s death (OR EARLIER DISPOSITION)....

[Emphasis added.] H.R. Rep. No 201, 97th Cong., 1st Sess., 161 (1981), 1981-2 C.B. 352 at 378.

“While it is true that the first parenthetical phrase in the committee report literally precludes a power in the surviving spouse exercisable in favor of any person other than the surviving spouse, we believe such a reading would be unnecessarily restrictive, and, as a practical matter, meaningless. It is axiomatic that a power to appoint exclusively to oneself includes the power to exercise such dominion and control over the property that one may give it to whomsoever one wishes. Thus, it is reasonable to believe that Congress intended that a spouse would be able to give the property away, especially in view of the second (emphasized) parenthetical.

“Consistent with this understanding of legislative history, and recognizing that the philosophy of section 2056 requires the imposition of the transfer tax only once during the lives of a husband and wife, we believe *the better reading of the legislative history would preclude a spousal power of appointment only where the exercise of the power would not be subject to transfer taxation; i.e., where the power is not a general power of appointment as defined in section 2514 of the Code.* [Emphasis added.]

“An interpretation requiring that a spouse must first take physical possession of the property prior to a transfer to a third party, would focus too much attention on the form of the transaction. It is sufficient that the exercise of the power by the spouse in favor of a third party would be subject to transfer taxation.”

<sup>5</sup> See also, Forms 3.33 and 3.34 of Horn, *Flexible Trusts and Estates for Uncertain Times* 79 (ALI-ABA, Philadelphia, 2003), [www.ali-aba.org/aliaba/BK26.asp](http://www.ali-aba.org/aliaba/BK26.asp), for sample withdrawal rights not limited to 5x5.

should be considered before granting a withdrawal right. Furthermore, if unexercised withdrawal rights accumulate over the years, more of the trust corpus will be taxable to the surviving spouse. Pvt. Letter Rul. 9034004.

### §3.3(f) Nonqualified Disclaimer Of QTIP Trust Property

The surviving spouse can, under certain circumstances, make a nonqualified disclaimer of QTIP trust property. A nonqualified disclaimer results in a taxable gift being made by the surviving spouse of the disclaimed amount. The IRS has permitted such an approach when the QTIP marital deduction trust is severed (on a fractional basis) into two resulting QTIP trusts, one of which will be subject to the nonqualified disclaimer. The surviving spouse can then make a nonqualified disclaimer of one of the resulting QTIP trusts. The nonqualified disclaimer of a resulting QTIP trust results in the surviving spouse making a gift of the spouse's income interest in that particular QTIP trust under IRC section 2511, and a gift of the remainder interest in that QTIP trust under IRC section 2519. The severance of the initial QTIP trust into two separate QTIP trusts does not negate the initial QTIP marital deduction election made on the decedent's federal estate tax return; nor does the nonqualified disclaimer of a resulting QTIP trust negate the initial QTIP marital deduction taken on the decedent's federal estate tax return. Pvt. Letter Ruls. 200324023 and 200250033.<sup>6</sup>

**Practice Point:** Note, however, that Treas. Reg. §25.2519-1(a) states that an assignment of any portion of the spouse's income interest in a QTIP trust constitutes a taxable gift of all the corresponding principal. Until a revenue ruling or Treasury regulations expressly sanction the divisible QTIP trust gift concept, a private letter ruling should be obtained before making such a gift.

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<sup>6</sup> In Pvt. Letter Rul. 200324023, the IRS held:

"In this case, Decedent's personal representative made a valid QTIP election under §2056(b)(7) on Decedent's [IRS] Form 706 for Separate Property QTIP. The proposed severance of Separate Property QTIP into Trust 1 [the QTIP sub-trust subject to the nonqualified disclaimer] and Trust 2 will have no effect on the election under §2056(b)(7) by Decedent's estate to qualify Separate Property QTIP for the federal estate tax marital deduction. Therefore, Trust 1 and Trust 2 will qualify as qualified terminable interest property trusts.

"When Taxpayer renounces her income interest in Trust 1, she will make a gift of her qualifying income interest under §2511. In addition, Taxpayer will be treated as having made a transfer of all of the property in Trust 1, other than her qualifying income interest, under §2519. Given that Taxpayer will exercise her right of recovery under §2207A(b) for any gift tax paid by her or by the trustee of Trust 1 on her behalf, Taxpayer's deemed gift of property under §2519 will be treated as a net gift. The value of Taxpayer's net gift under §2519 will be equal to the fair market value of Trust 1's property, determined on the date of the disposition (including any accumulated income and not reduced by any amount excluded from total gifts under §2503(b) with respect to the transfer creating the interest), less the value of Taxpayer's qualifying income interest in Trust 1 on the date of disposition, minus the amount of gift taxes actually paid by Taxpayer or by the trustee of Trust 1 on behalf of Taxpayer.

"In this case, the entire amount that will be deemed transferred by Taxpayer under §§2511 and 2519 will pass to Charitable Remainder Unitrust for the benefit of Daughter, Charity 1, Charity 2, and Charity 3. Charitable Remainder Unitrust satisfies the requirements of §664(d) and, therefore, the transfers by Taxpayer under §§2511 and 2519 will qualify for the gift tax charitable deduction under §2522(a). In addition, the property in Trust 1 that is deemed to be transferred under §2519 will not be included in Taxpayer's gross estate under §2044(a) because of the application of §2044(b)(2).

"Upon Taxpayer's renunciation of her qualifying income interest in Trust 1, she will not be deemed to have made a gift of all or any portion of the property in Trust 2 because Trust 2 will be established and funded as a separate trust and will not be affected by Taxpayer's renunciation of her qualifying income interest in Trust 1.

"Finally, pursuant to the representations made herein, Trust 1 and Trust 2 will be separate trusts for all purposes from the effective date of [the agreement with the charity to make a nonqualified disclaimer of Trust 1]. As a result, Taxpayer's interest in Trust 1 will be separate and distinct from her interest in Trust 2. Therefore, when Taxpayer renounces her entire interest in Trust 1, Taxpayer's interest in Trust 2 is not treated as a retained interest for purposes of §2702(a)(1). Accordingly, Taxpayer's renunciation of her entire income interest in Trust 1 will not result in Taxpayer's interest in Trust 2 being valued at zero under §2702."

### **§3.3(g) Sale Of QTIP Property For Less Than Fair Market Value**

The ability of a third party to purchase property from a trust for less than its fair market value is the power to appoint principal to someone other than the surviving spouse. Pvt. Letter Rul. 9139001. *See also*, Pvt. Letter Ruls. 9606008 and 9147065. *See, Estate of Clyde L. Rinaldi v. United States*, 38 Fed. Cl. 341 (1997), *aff'd without op.*, 178 F.3d 1308 (Fed. Cir. 1998), *cert. denied*, 526 U.S. 1006 (1999), where the decedent's son had the option to purchase stock (that had been allocated to the marital deduction trust) for a bargain price under a buy-sell agreement.

### **§3.3(h) Trustee's Power To Adjust Income And Principal**

Under new (revised) regulations effective January 2, 2004, which are discussed in section 6.2, below, a trustee's power under state law that permits the trustee to adjust between income and principal to fulfill the trustee's duty of impartiality between the income and remainder beneficiaries (i.e., a trustee's ability to use a total return investment strategy and adopt a unitrust definition of income, or a trustee's ability to make adjustments between income and principal) will not constitute a power to appoint trust property to a person other than the surviving spouse. Treas. Reg. §20.2056(b)-7(d)(1).

### **§3.4 SOLE BENEFICIARY REQUIREMENT**

The sole beneficiary of the QTIP trust must be the surviving spouse. The trustee cannot have the power to distribute trust assets to anyone other than the surviving spouse. *Estate of Allen L. Weisberger v. Commissioner*, 29 T.C. 217 (1957); Treas. Reg. §20.2056(b)-7(h), Example 4. *See also*, Pvt. Letter Ruls. 9147065 and 8508002. *See*, Paragraphs 3.6(A) and (B) (alternative 1) of Sample MD Trust.

### **§3.5 ANNUITIES AND THE QTIP ELECTION**

An annuity for a surviving spouse's lifetime qualifies as QTIP if the decedent's will or trust was executed on or before October 24, 1992, and the decedent was under mental disability or died before October 24, 1995. Treas. Reg. §20.2056(b)-7(e)(1), (5). A joint and survivor annuity is automatically treated as QTIP if the surviving spouse is the only recipient after the spouse's death, unless an affirmative election out of QTIP status is made on the decedent's federal estate tax return. IRC section 2056(b)(7)(C).

### **§3.6 PARTIAL QTIP ELECTION**

An executor may elect QTIP treatment for a "specific" portion of potential QTIP property. IRC section 2056(b)(7)(B)(iv). A partial QTIP election may be made with a formula provision similar to that used in drafting a pecuniary or fractional marital deduction formula. (*See*, Chapter 15, below, for a discussion of marital deduction formulas.) This means that any change in valuation of the deceased grantor's assets upon audit or by taking deductions on the estate tax return versus the income tax return would not affect the marital deduction if the formula clause were designed to reduce the estate tax to the lowest possible tax. Treas. Reg. §20.2056(b)-7(h), Examples 7 and 8. *See also*, Pvt. Letter Rul. 9043015.

#### **§3.6(a) Fraction Or Percentage Partial Election Only**

The specific portion for which QTIP treatment is elected must be expressed as a fraction or percentage of the QTIP trust, or may be defined by means of a formula. Treas. Reg. §20.2056(b)-7(b)(2)(i), -7(h), Examples 7 and 8. *See also*, Pvt. Letter Rul. 9043015.

**Practice Point:** A formula definition is advisable since it will automatically adjust if the estate tax values, deductions, or taxable gifts change on audit. In Pvt. Letter Rul. 9327005 the executor made a partial QTIP election for a specified percentage and stated on the federal estate tax return that the