

TRUSTS AND ESTATES

Lifetime 'QTIPable' Trusts for Gift, Estate Tax Exemption Planning

With the change in political control in Washington, what changes are on the horizon and what estate tax planning should be done early in 2021 for those high net worth individuals who have not used all of their available exemption?

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With the change in political control in Washington, what changes are on the horizon and what estate tax planning should be done early in 2021 for those high net worth individuals who have not used all of their available exemption? The 2017 TCJA doubled the amount of the federal gift and estate tax exemption. For 2021 the exemption is \$11.7 million per taxpayer. Absent any sooner change, the 2017 law will “sunset” at the end of 2025 and the exemption will revert back to the pre-2017 level of \$5 million (adjusted annually for inflation).

Currently, although the Biden administration tax proposal includes a reduction in the estate tax exemption, it has not prioritized any tax law changes that would reduce the exemption to the pre-2017 level, or even a lower number. Such targeted legislation affecting income and estate and gift tax rates could be passed later this year, at the earliest, and is unlikely to

be made retroactive to Jan. 1, 2021. As of this writing, the legislative focus is on a pandemic relief package and other pressing economic issues.

The uncertainty of when the exemption may be reduced makes flexibility in planning techniques very attractive. In this vein, the estate planning options discussed in our 2020 Federal Gift and Estate Tax Planning Alerts last October 2020 (Parts I and II) suggest an additional 2021 planning option for married couples who have available exemption. The basic concept is for one spouse to create and fund a trust for the benefit of the other spouse (a SLAT) for which the decision to treat it as a taxable gift that uses exemption or as a gift protected from tax by the marital deduction can be deferred until October 2022. This can be done using a so-called “QTIPable” trust structured according to the federal tax law and regulations that is *eligible* to qualify for the marital deduction from gift / estate tax. The word “eligible” is what provides flexibility because the election to determine whether the trust will use the grantor’s exemption or not will be made on the grantor’s 2021 gift tax return, due (on extension) Oct. 15, 2022.



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In essence, a “QTIPable” trust must provide that the grantor’s spouse is the sole beneficiary during his or her lifetime and that all income of the trust be paid to the grantor’s spouse. In order for the trust to qualify for the marital deduction, the “QTIP” election must be made on the grantor’s timely filed gift tax return. The effect is to create and fund a trust early in 2021 before the effective date of legislative action, but to permit the grantor to have about a year and a half of hindsight before deciding, which may be well after the effective date of a change in the exemption amount.

If the QTIP election is *not* made, the full value of the gift to the trust will be a taxable gift for 2021 and sheltered from gift tax by the grantor’s remaining exemption. If the exemption has been reduced, effective *after* the date of funding the trust, the QTIP election likely would not be made by the grantor, thus locking in the grantor’s use of the full \$11.7 million exemption amount.

On the other hand, if the tax law has not changed by October 2022,

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all options are still open to the grantor: *elect* full QTIP treatment for the trust—effectively meaning no taxable gift was made—or make the election and take full advantage of his or her unreduced exemption. If the QTIP election is made because the grantor regrets the decision to have made such a large gift, the grantor can, in effect, unwind the gift and, if he or she chooses and the law does not change, use his or her remaining exemption in the future for gifts to children or other estate planning techniques.

Once the QTIP election is made, the trust assets remaining at the spouse's death will be includable in the beneficiary spouse's taxable estate for federal estate tax purposes—or, the trustee might terminate the trust, so that the trust property would be distributed to the grantor's spouse.

The trust terms could give the beneficiary spouse a broad testamentary power of appointment. If, in the future, it appears that the grantor may need the trust assets if the beneficiary spouse is the first to die, the beneficiary spouse could direct that the trust property be held in continuing trust for the grantor's benefit after the beneficiary spouse's death. Inclusion of this power in the trust agreement should not cause the gift to be incomplete, but there is a risk that if the power is exercised in favor of a trust that includes the grantor as a beneficiary, the trust will be deemed a "self-settled trust" and be included in the grantor's estate. If the beneficiary spouse has this power and wishes to exercise it, prudent practice is for the Will exercising the power to be created sometime in the future to avoid any appearance of a pre-arranged plan.

One disadvantage from an estate tax planning perspective of a QTIP-style trust for which a QTIP election is not made, however, is that all net

trust accounting income must be distributed to the beneficiary spouse, so there is no flexibility for trust income to be accumulated or distributed directly to descendants, and thus kept out of the beneficiary spouse's taxable estate. Income accumulation/distribution to descendants is only possible in a trust that does not meet the requirements of a QTIP trust. A trust along these lines provides somewhat more limited flexibility to defer the decision of whether to use exemption to protect the gift by having the beneficiaries of the trust disclaim the gift so that it reverts to the grantor. The period in which to make this decision to defer gift tax treatment is only nine months, and may be more complicated if the decision must involve children.

One way to minimize the income distribution disadvantage of a QTIP trust could be to use an LLC to hold the underlying cash/investment assets used to fund the trust. The actual income earned by the assets could be accumulated in the LLC for the remainder beneficiaries and the trust would not receive income that must be distributed to the beneficiary spouse (although the trust must require that the spouse can insist the trust hold income producing assets). Because the trust will be a grantor trust for income tax purposes, income tax on the LLC earnings, even though not distributed, would be paid by the grantor.

Although it is a more complicated structure, use of the LLC also would provide several other potential benefits. Gifts of a partial interest in an LLC could allow for leverage of the grantor's gift tax exemption through valuation discounts applied to the value of the gifted shares of the LLC.



In addition, the value of a gift of LLC interests may be limited by a formula/adjustment provision in the gift assignment so that total gifts do not inadvertently exceed the available gift tax exemption. For gifts of interests in an entity, a formal appraisal will be needed as of the date of the gift for the gift tax return; in general, the appraisal should be obtained sooner rather than later.

From an income tax perspective, property includable in the taxable estate of the beneficiary spouse (if a QTIP election is made) will under current law receive an adjustment in basis to date of death value, but not so for non-QTIP trust property. For this reason, the appreciation in the trust property after the date of the gift and before October 2022 may be a factor in the decision whether to make a QTIP election.

The possibility of retroactive federal legislation that might apply to any trust created from Jan. 1, 2021 forward would defeat a 2021 QTIPable trust strategy (but without triggering gift tax). For those who are less concerned about the risk of that prospect, a discretionary SLAT for the benefit of the donor's spouse and descendants is certainly an option. But for those who do not wish to risk the possibility of imposition of a gift tax on a retroactive basis, the QTIPable trust may be a good solution.