The Marital Deduction, QTIP Trusts and Coordinated Estate Planning

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April 2023
Agricultural Law and Taxation Blog, by Roger McEowen: https://lawprofessors.typepad.com/agriculturallaw/
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Overview

A married person can leave an unlimited amount of property outright to the surviving spouse at death with no resulting federal estate tax. *I.R.C. §2056.* There is also an unlimited gift tax marital deduction. *I.R.C. §2523*. This means that interspousal transfer, either during lifetime or at death, may be made tax-free regardless of amount. In addition, for lifetime spousal transfer, no gift tax return need be filed.

But, to qualify for the marital deduction, the transfer to the spouse must be outright. It cannot be a life estate, or a terminable interest as defined in *I.R.C. §2056(b).* That is, unless the terminable interest is a qualified terminable interest property (QTIP) interest. *I.R.C. §2056(b)(7).*

A QTIP trust was at the heart of a multi-year family dispute that the U.S. Tax Court recently decided. The case points out that QTIP trusts must be utilized carefully to avoid negative tax consequences and family disputes.

QTIP Trusts – The Basics

A QTIP trust is similar to a marital A/B trust set-up. They are both irrevocable "credit shelter" trusts that take effect when the first spouse of a married couple dies. With an A/B trust arrangement, an allocation of the first spouse's assets at the time of death is done. In general, for an estate potentially subject to federal estate tax, an amount equal to the estate tax unified credit should be taxed in the first spouse's estate which would then be offset by the credit. The balance should pass to the surviving spouse outright and qualify for the marital deduction. This is the A/B trust arrangement – a credit shelter trust and a marital deduction trust. The amount in the credit shelter trust is taxed in the first spouse's estate but offset by the unified credit, and the amount in the marital deduction trust is offset by the marital deduction. The result is often little to no tax in the first estate and estate tax optimization in the second spouse's estate. The difference between a QTIP trust and a marital trust is that with a QTIP trust has the right to income from the trust (and, perhaps, principal) but control does not pass to the surviving spouse. With a marital trust the surviving spouse controls the asset distribution.

In situations, such as a second marriage, where the first spouse to die wants to ensure the passage of property to someone other than the surviving spouse, the marital deduction would be lost to the first spouse's estate without the QTIP provision. But, with a QTIP the first spouse can control disposition of the property upon the surviving spouse's death while still qualifying the property for the marital deduction in the decedent's estate.

QTIP requirements. An election must be made to achieve QTIP treatment and certain requirements must be satisfied – 1) the property must pass to a spouse from the decedent; 2) the decedent's spouse must be entitled to all of the income from the property for life, payable at least as frequently as annually; and 3) no one, including the spouse, may have a power to appoint any part of the principal to anyone other than the spouse during the spouse's life. If these conditions are satisfied, the estate of the first spouse to die, can claim a marital deduction for the value of the property in the QTIP trust.

Note: A QTIP trust does not necessarily restrict the surviving spouse's ability to withdraw principal, but it is common that a QTIP trust does not grant such a withdrawal power

Estate of Kalikow v. Comr., T.C. Memo. 2023-21

Basic facts. A prominent New York City real estate developer died in 1990 with a will that created a QTIP trust for the benefit of his surviving wife. The QTIP trust contained ten income-producing apartment buildings in New York City. The trustees were instructed to pay the trust's net income at least quarterly to the surviving spouse for life along with discretionary principal distributions, and then the assets were to be divided and paid to trusts for the benefit of the couple's two adult children.

In 1997, the couple's son and the family's CPA (as trustees of the trust) created a Family Limited Partnership (FLP) and the QTIP trust was transferred to the FLP in exchange for a 98.5 percent partnership interest. At the time of the surviving spouse's death in early 2006, the QTIP trust held the FLP interest, $835,000 of cash and marketable securities. After payment of expenses, the balance of the surviving spouse's estate passed to charity. The couple's daughter was also added as a trustee. Under the surviving spouse's will, the trust was responsible for its share of estate tax arising from the inclusion of the trust property in the decedent's estate.

A grandchild of the couple's petitioned a local court to compel the trustees to render an account of income distributions from the QTIP trust to the surviving spouse. The trustees filed competing reports and the CPA-trustee claimed that the FLP had failed to distribute to the trust its full share of FLP distributable amounts which diminished the decedent's receipt of trust income by almost $17 million. The CPA-trustee requested the court to order he and the other trustee to pay this amount, plus interest, to the estate from the trust's income. However, the decedent's children (appointed as limited administrators of their mother's estate) filed a petition claiming that there had been an overdistribution of $3.27 million from the trust to the surviving spouse. The matter was litigated for a decade and the parties reached a settlement agreement that the trust would pay the estate $9.2 million which represented unpaid income of $6.5 million and $2.7 million in fees from January 1, 2002, through 2005.

The executor of the surviving spouse's estate (the CPA who was also a co-trustee of the QTIP trust) filed Form 706 (federal estate tax return) in early 2007 reporting "other miscellaneous property" of $31,869,441 including $4,632,489 of undistributed income from the pre-deceased spouse's estate and a yet to be determined claim of the estate against the trustees of the pre-deceased husband's trust for loss of profits, excess taxes paid, interest and other damages. The children filed a Form 706 on the same day that mirrored the executors' Form 706, but also included the assets of their father's trust –

another $43.3 million (which included the 98.5 percent FLP interest and the cash and marketable securities).

The IRS position and the Tax Court. The IRS issued a notice of deficiency asserting that the trust's value of the 98.5 percent FLP interest was $105,664,857 instead of $42.465 million as reported on the limited administrators' Form 706. The IRS also reduced the estate's assets by the value of the pending claim against the trust. The executors and the limited administrators both filed a Tax Court action claiming that the IRS' reduction of the gross estate by the $4.632,489 of the estate's claim against the trust. The executors claimed that the pending claim should be included in the gross estate at $16,946,827, and the limited administrators asserted that the value of the trust should be reduced by the amount of any claim allowed for undistributed income due the estate from the trust and the resulting net value be included in the gross estate under I.R.C. §2044. Thus, the issues before the Tax Court were (1) whether the value of the QTIP trust assets included in the surviving spouse's gross estate should be reduced by the agreed-upon undistributed income amount; and (2) whether the surviving spouse's estate could deduct any part of that undistributed income as an administration expense under I.R.C. §2053. The estate asserted that the gross estate should be reduced, and an administration expense could be claimed. The IRS disagreed.

Note: The executors and limited administrators stipulated that the value of the trust's FLP interest at the date of the decedent's death was $54,492,712.

The Tax Court noted that under I.R.C. §2044(a), the QTIP trust property was to be included in the surviving spouse's gross estate at fair market value *as of the date of her death*. Thus, the stipulated value of the trust's FLP interest plus the cash and marketable securities of $55,327,712 was included in her gross estate. The Tax Court disagreed with the assertion that the gross estate should be decreased by the amount of the agreed-upon settlement amount. The Tax Court pointed out that by the terms of the trust, the FLP was not liable for the settlement payment and, as such, the liability had no impact on the date of death fair market value of the trust's FLP interest. The Tax Court agreed with the assertion of the IRS that the trust would have an offsetting claim against third parties for the undistributed income payment liability. In addition, the enhanced value of the surviving spouse's gross estate increased the estate's charitable contribution by a like amount. The Tax Court also concluded that the estate was not entitled to deduct any part of the agreed-upon settlement payment other $838,044 attributable to paying out commissions.

Estate Planning and Family Structure

The *Kalikow* case presents an interesting illustration of the family dynamics that estate planners often must deal with. This apparently was not a second marriage situation for either spouse – at least there is no indication of that by the Tax Court. This raises a question as to why a QTIP trust was created under the terms of the husband's will? Did he suspect that if his wife survived him that she would disinherit their children? Were there creditor issues? The husband died at age 70 after battling Parkinson's disease for 36 years. Indeed, her will left the residue of her estate to charity rather than the children. Also, the co-trustees of the QTIP trust were a son, a non-family member CPA and the surviving spouse. After the death of the surviving spouse, their daughter was added as a co-

trustee. But neither child was an executor of their mother's estate. Were they estranged? The Tax Court opinion doesn't shed any light on that question either.

Clearly, planners must think about the potential for conflict between the surviving spouse and the remainder beneficiaries that a QTIP trust can create. Those conflicts typically involve investment decisions, tax strategies and the administration of the trust. These conflicts are caused ty the surviving spouse not having any control over the trust and that the final disposition of the trust remains subject to the prior deceased spouse's control. This means that the planner must carefully evaluate the relationship between the surviving spouse and the remainder beneficiaries and whether the surviving spouse has income and assets outside the QTIP trust.

It is a bit puzzling why a QTIP trust was utilized in *Kalikow* – a multimillion-dollar estate. With a QTIP trust, the trustees had no ability to allocate trust income and principal among the next generation of family members as a long-term tax minimization strategy. While a basis step-up of the QTIP assets is achieved in the surviving spouse's estate, in such a large estate as Kalikow, the unified credit is woefully inadequate to eliminate estate tax in the survivor's estate. That might explain the charitable gift of the remainder of the surviving spouse's assets, but if that is a correct assumption why not simply utilize a standard credit shelter trust and give the surviving spouse the power to control the assets consistent with optimal tax planning? Also, the difference in the beneficiaries of the surviving spouse's estate and the QTIP trust triggers a tax apportionment "tax trap" that pegs the estate tax liability on the assets of the QTIP trust.

The *Kalikow* estate also involve overlapping roles of fiduciaries and professionals – the family CPA was also a co-trustee and executor. Rarely is that structure recommended. With the inherent conflict given the differences between the disposition of the surviving spouse's estate and what had been established via the QTIP, perhaps the FLP could have been structured in a manner to help minimize conflict.

Conclusion

In the end, the QTIP was valued at approximately $55 million (pre-tax) and the unpaid income amount was settled at around $6.5 million. The legal fees are not known, but they would have been substantial. The family litigation dragged on for over a decade. Was it worth it?

QTIP trusts can be beneficial, and they do have their place, but clearly they are not for everyone. Estate planning is difficult and often there is a need to coordinate the planning over subsequent deaths and even subsequent generations.

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