

Qualified Terminable Interest Property Trust (QTIP)

What Is Qualified Terminable Interest Property?

Qualified terminable interest property (QTIP) is property in a decedent's estate that, even though subject to certain restrictions, can still qualify for the estate tax marital deduction. The term also includes property given to a spouse during life that qualifies for the gift tax marital deduction, even though it is subject to similar restrictions.

Brief Review of the Marital Deduction

When people leave property to others at death--or give property away during life that exceeds or does not qualify for the gift tax annual exclusion--that property is generally subject to a federal estate tax (death transfer) or a federal gift tax (lifetime transfer) if the total transfer exceeds the applicable exclusion amount sheltered from federal estate tax by the applicable credit amount. However, when property is left (or given) to a surviving spouse, the "unlimited marital deduction," allows spouses to transfer any amount of property between themselves, during life or at death, without triggering either the federal estate tax or the federal gift tax.

Terminable Interests

Property left (or given) to the spouse cannot be a "terminable interest" if it is to qualify for the marital deduction.

So, what is a "terminable interest"? Basically, it is an interest in property that can expire due to the passage of time, or that can terminate due to the occurrence of some future event, or the failure of some event to occur.

Example #1: Husband leaves wife a life income interest in a trust. At her later death, the trust corpus will be held for husband's invalid brother. Wife has no power, by will or otherwise, to change the use of the trust corpus. She has a terminable interest in the trust, and her interest will not qualify for the marital deduction in husband's estate.

Example #2: Wife leaves Shady Acres Ranch to husband, but only for so long as he remains unmarried following her death. If he remarries, Shady Acres will pass to wife's niece. Husband has a terminable interest in Shady Acres, and it will not qualify for the marital deduction in wife's estate.

In Example #2, did we wait and see whether husband in fact remarries before we draw our conclusion? No. The mere fact that he could lose Shady Acres by virtue of remarriage is enough to cause forfeiture of the marital deduction.

"Qualified" Terminable Interests

While terminable interests generally do not secure the marital deduction, the law does allow certain types of terminable interests to qualify for the deduction.

First, such interests have to meet certain legal criteria that make them a "qualified" terminable interest. Second, the executor of the deceased spouse's estate (or the donor-spouse in the case of a lifetime gift) must elect to take the marital deduction for a terminable interest that has been so "qualified."

Qualification Requirements for QTIPs

Two kinds of terminable interests can be "qualified":

1. lifetime income interests, and
2. income interests in charitable remainder trusts.

In both cases, the surviving spouse's interest in property can terminate at her death, but the law will still allow the marital deduction if the requirements described below are met.

In community property states, a spouse's interest in the participant-spouse's qualified retirement plan, IRA, or SEP, arising from community property laws, may qualify for QTIP treatment if the participant-spouse dies before the nonparticipating spouse.

Lifetime Income Interests

This is also called the "qualifying income interest for life." Often, the surviving spouse has an income interest in property held in trust, but the trust is not a necessity. In all cases, the surviving spouse must have--

- the right to all income from the property for as long as she (or he) lives,
- this income must be payable annually or at more frequent intervals,
- no one, not even the surviving spouse herself, may have a power to appoint the property to anyone other than the surviving spouse.
- the deceased spouse's executor (or the donor-spouse) must irrevocably elect to take the marital deduction for the property on the federal estate (or gift) tax return.

Income Interests in Charitable Remainder Trusts

Suppose the spouse is the income beneficiary of a charitable remainder annuity trust or unitrust. The spouse's income interest will eventually terminate. At that time, the charity will succeed to the full interest in the trust property; the spouse has no power to dispose of the trust property by will. However, if the spouse and the charity are the only trust beneficiaries, the trust can qualify for the marital deduction.

In this case the spouse does not have to have a lifetime income interest. The income interest could expire after a period of years, say 20, when the charity is scheduled to take over.

Tax Consequences of QTIPs

When regular property qualifies for the marital deduction at the first spouse's death, it avoids estate tax at that time. But any amount that remains at the second death is taxed in the surviving spouse's estate. That's usually because the spouse either received it outright or had a general power of appointment over it. So, the IRS essentially says, no tax at the first death, but we're going to even things up at the second death.

With the QTIP, we get the marital deduction at the first death, even though technically the terminable interest rule is violated. The law grants us an exemption for QTIPs. But now, when the surviving spouse dies, is there anything to tax in the second estate? Technically, no; the interest in the property terminated at death. There's nothing the survivor owns that can pass on to anyone else. Does that mean we can avoid the estate tax at both deaths?

No. The tax code wants the taxes due at the second death. The tax law allowed us to violate the terminable interest at the first death; it evens the score by taxing property that technically does not pass through the second spouse's estate to the eventual heirs.

The net effect of all these legal fictions is that the tax is delayed until the second death, even though the first spouse to die actually controls how the property is ultimately distributed.

Why Use QTIPs?

There are several reasons why QTIPs make sense, and why they are commonly used:

A QTIP trust adds flexibility to the estate plan of the first spouse to die. Since the final decision regarding whether to qualify the QTIP property for the marital deduction is delayed until after the estate owner's death, the current circumstances of the surviving spouse and other beneficiaries can be taken into account.

- The surviving spouse can be assured of receiving all of the income from the QTIP property for his or her entire lifetime.
- The estate owner can restrict the ultimate disposition of the QTIP property without sacrificing the marital deduction.

Sometimes it is inappropriate to leave property outright to a surviving spouse--perhaps because the spouse is aged, infirm or not sophisticated in financial affairs or property management. The QTIP trust allows property to be managed for the spouse's benefit without these burdens.

The QTIP trust is especially useful in second marriage situations. The first spouse to die can be assured that the property will pass eventually to his or her children or other heirs, rather than to the surviving spouse's children from a prior marriage, while still providing lifetime financial security to the surviving spouse.

The QTIP also addresses the "remarriage fear" that many estate owners have. If property is left outright to a surviving spouse who later remarries, the property could wind up in the hands of the new spouse. The QTIP trust provides for a surviving spouse, but retains control over the ultimate disposition of the property.