Steve Leimberg's Estate Planning Email Newsletter - Archive Message #2040

Date: 20-Dec-12
From: Steve Leimberg's Estate Planning Newsletter
Subject: **Austin Bramwell and Vanessa Kanaga on PLR 201243004**

"The authors have argued that the beneficiary of a QTIP trust can make taxable gifts of trust property yet thereafter retain the ability to receive distributions of principal in the discretion of an independent trustee. The strategy, if sound, would have a number potential benefits.

In PLR 201243004, the IRS ruled favorably on several aspects of the strategy. While it may not be cited as precedent, the ruling provides comfort to taxpayers and advisers who are considering having the beneficiary of a QTIP trust make taxable gifts of trust property but retain a discretionary interest in principal.

While some of the IRS's rulings in PLR 201243004 are unexceptional, others break new and favorable ground. In particular, the ruling supports the view that a beneficiary of a QTIP trust may assign his or her income interest and be deemed to have made a taxable gift of principal, yet thereafter remain a discretionary principal beneficiary."

We close this week with **Austin Bramwell** and **Vanessa Kanaga's** commentary on PLR 201243004, a ruling they believe can greatly facilitate marital deduction planning and make it more tax-efficient, especially if Congress renews the new "portability" provisions.

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Vanessa Kanaga is an associate at **Hinkle Law Firm, LLC**, in Wichita, Kansas, practicing in the areas of Estate Planning, Family Business Planning, Probate and Trust Services. She is a member of the New York State Bar and the Kansas Bar. The views expressed herein are her own.

Here is their commentary:

EXECUTIVE SUMMARY:

The authors have argued that the beneficiary of a QTIP trust can make taxable gifts of trust property yet thereafter retain the ability to receive distributions of [i] principal in the discretion of an independent trustee. The strategy, if sound, would have a number potential benefits. For example, it would permit:

- a QTIP beneficiary to make substantial taxable gifts without losing access to his or her wealth;

- a married couple to avoid state death taxes on the difference between state and federal estate tax exemption amounts available to the estate of the first spouse to die (the "first decedent"); and

- a surviving spouse, after the first decedent's death, to choose between either creating the equivalent of a traditional credit shelter trust or relying on the portability election to shelter assets from estate tax at the surviving spouse's death.

In PLR 201243004, the IRS ruled favorably on several aspects of the strategy. [ii] While it may not be cited as precedent, the ruling provides comfort to taxpayers and advisers who are considering having the beneficiary of a QTIP trust make taxable gifts of trust property but retain a discretionary interest in principal.

FACTS:

Taxpayer and his wife created a joint revocable trust. The trust provided that, upon the first decedent's death, the trust property would be divided into a credit shelter trust, a trust intended to qualify as a QTIP trust and a trust of the surviving spouse's property (the "survivor's trust").

The trustee had the power to divide the QTIP trust into separate subtrusts and make the "reverse" QTIP election for GST tax purposes with respect one of the subtrusts. Distributions of principal from the QTIP trust were authorized if income payments from the credit shelter trust, the survivor's trust and the QTIP trust were "insufficient." [iii]

Upon his wife's death, the taxpayer was appointed as executor of her estate. Although an estate tax return was filed, the accountants who prepared the return failed to make a QTIP election, to allocate the wife's GST exemption or to make any "reverse" QTIP election for GST tax purposes.

The taxpayer proposed to take the following steps:

(1) Divide the QTIP trust into two trusts (the "Exempt Trust" and the "Non-Exempt Trust");
(2) File a supplemental estate tax return making the QTIP election, allocating the wife's remaining GST exemption to the Exempt Trust and making the reverse QTIP election with respect to the Exempt Trust;
(3) Petition a state court to divide the Non-Exempt Trust into two trusts ("Trust 1" and "Trust 2") and modify Trust 1 so as allow the taxpayer to assign his income interest in Trust 1 to his children;
(4) Assign his income interest in Trust 1 to his children; and [iv]
(5) Waive his right to recover gift tax under Section 2207A.

Trust 1 would continue in existence after taxpayer's assignment of his income interest. The governing instrument would continue to permit distributions of principal to taxpayer.

The IRS granted the taxpayer an extension of time to make the QTIP election, to allocate GST exemption to the Exempt Trust and to make the "reverse" QTIP election with respect to the Exempt Trust. The IRS also ruled as follows:

(1) Taxpayer's assignment of his income interest in Trust 1 would be a taxable gift under Section 2511;
(2) Taxpayer would be treated under Section 2519 as having made a completed gift of the principal of Trust 1;

(3) The principal of the Exempt Trust and Trust 2 would not be deemed to have been transferred under Section 2519;
(4) Trust 1 would not be included in taxpayer's gross estate under Section 2044;
(5) In determining the value of the taxpayer's gifts of his interests in Trust 1, the value of his interests in the Exempt Trust and Trust 2 would not be valued at zero under Section 2702 [v];
(6) By waiving his right of recovery under Section 2207A(b), the taxpayer would be deemed to have made a gift of unrecovered gift tax;
(7) Neither the division of the QTIP trust into the Exempt Trust and Non-Exempt Trust nor the division of the Non-Exempt Trust into Trust 1 and Trust 2 would cause the Exempt Trust, Trust 1 or Trust 2 to fail to qualify as a QTIP trust;
(8) Taxpayer's assignment of his income interest in Trust 1 would not cause the Exempt Trust or Trust 2 to fail to qualify as a QTIP trust; and
(9) The division of the Non-Exempt Trust into Trust 1 and Trust 2 would not cause recognition of gain or loss for income tax purposes.

COMMENT:

While some of the IRS's rulings in PLR 201243004 are unexceptional, others break new and favorable ground. In particular, the ruling supports the view that a beneficiary of a QTIP trust may assign his or her income interest and be deemed to have made a taxable gift of principal, yet thereafter remain a discretionary principal beneficiary.

Some of the important issues that PLR 201243004 addresses, implicitly or explicitly, are as follows:

1. Triggering Section 2519 one QTIP trust at a time. Section 2519 provides that a disposition of an income interest in a QTIP trust shall be treated for gift and estate tax purposes as a transfer of the entire trust other than the income interest. If a spouse is a beneficiary of multiple QTIP trusts that were created at the same time and assigns the income interest in only one of the trusts, he or she should be deemed under Section 2519 to have transferred interests in that trust only and not any other QTIP trust.[vi]

   The result is less certain, however, where a QTIP trust is severed into multiple trusts after it was originally created.[vii] Fortunately, the IRS has repeatedly ruled that, where a QTIP trust is severed, the spouse's assignment of an income interest in one of the resulting trusts will not cause a deemed transfer of interests in the other resulting trusts.[viii] PLR 201243004 adds to the list of such rulings.[ix]

   The ability to sever a QTIP trust and then trigger Section 2519 with respect to only one of the resulting trusts is helpful, as it permits a spouse to "fine-tune" the amount of his or her deemed gift under Section 2519. For example, if a surviving spouse wishes to use up his or her gift tax exemption (including any exemption that was "inherited" from the first decedent) by assigning an income interest in a QTIP trust, but the value of the trust exceeds the beneficiary's exemption, the trust could first be severed into two portions, one of which of which would be equal in value to the beneficiary's remaining gift tax exemption amount. The beneficiary could then assign an income interest in that trust and thereby avoid making gifts that exceed his or her remaining gift tax exemption.

2. Marital deduction permitted despite ability to assign income interest.

Section 2056(b)(7)(B)(i)(II) prohibits any person (including the spouse [x]) from having a power to appoint property of a QTIP trust to a person other than the spouse. Nevertheless, it seems clear that a spouse's ability to assign his or her income interest should not disqualify a QTIP trust for the marital deduction.[xi] In PLR 201243004, Trust 1 qualified as QTIP despite that the taxpayer planned to make his income interest assignable. The ruling confirms, therefore, that the lack of a blanket "spendthrift" clause will not cause a trust to fail to qualify for the marital deduction.

3. Completed gift of principal despite retained discretionary interest. The taxpayer's deemed transfer of principal in PLR 201243004 was held a completed gift even though he retained the ability to receive principal in the discretion of the trustee. The holding is consistent both with the regulations under Section 2519[xii] and authorities holding that a gift is not rendered incomplete merely because the donor retains a discretionary interest in the transferred property.[xiii] In that respect, a deemed gift of QTIP principal is similar to a discretionary trust created by a donor for his or her own benefit in a jurisdiction where trust assets will generally be protected against the claims of the donor's creditors.[xiv] As discussed below, however, a deemed transfer of QTIP trust property presents a lower risk of gross estate inclusion than a "self-settled" trust and is therefore a safer technique for making taxable gifts while not losing access to the transferred property.

4. Minimal risk of gross estate inclusion at death of surviving spouse. PLR 201243004 holds that the principal of Trust 1 would not be included in the surviving spouse's gross estate under Section 2044. That section normally includes the property of a QTIP trust in the beneficiary's gross estate at death. It does not apply, however, if property was deemed to have been transferred during lifetime under Section 2519.[xv] As the principal of Trust 1 was deemed to have been transferred under Section 2519, the IRS correctly concluded that Section 2044 would not apply at death.

   The more significant issue is whether, following a deemed transfer under Section 2519, the principal of a QTIP trust will be included in the surviving spouse's gross estate under Section 2036. On that issue, the IRS stated that "no opinion is expressed or implied." Despite that disclaimer, some plausible inferences on the applicability of Section 2036 can be drawn.

   First, it does not appear that the property of Trust 1 could be included in the taxpayer's gross estate under Section 2036 in virtue of any enforceable right he might have retained. Although the IRS does not say so, it is unlikely that the taxpayer retained, for example, an enforceable right to distribute the QTIP principal to himself.[xvi] Such a right, after all, would have caused the deemed transfer of principal under Section 2519 to have been incomplete for gift tax purposes,[xvii] contrary to the IRS's own ruling that the deemed transfer was a completed gift.

   That said, an interest or right is still treated as having been retained or reserved under Section 2036, if, at the time of the transfer, there was an understanding, express or implied, that the interest or right would later be conferred.[xviii] The IRS's reluctance to rule on whether the QTIP property would be included in the taxpayer's gross estate under Section 2036, therefore, is not surprising: As the existence of an implied understanding is a question of fact, the IRS routinely declines to rule on whether property will be include in a taxpayer's gross estate tax death under Section 2036.[xix]

Nevertheless, it seems that it would be difficult for the IRS to establish that an implied understanding existed. An implied understanding has only been found to exist where there was an actual transfer of property to a cooperative (or presumably cooperative) transferee.[xx] When a surviving spouse assigns an income interest in a QTIP trust, by contrast, no actual transfer of principal takes place; the "transfer" of principal that is deemed to take place is purely notional. Any "understanding" under which the trustee accepted the property in the first place would typically have been reached prior to the deemed transfer under Section 2519 and often with a person (namely, the creator the QTIP trust or other person from whom the trustee accepted his or her appointment) other than the beneficiary. The spouse, in other words, may cause a "transfer" of principal under Section 2519 without any involvement or even communication with the deemed "transferee." It is difficult in such circumstances to see how an understanding between the two could have arisen.

That said, to minimize the risk that an "implied understanding" will be found to exist following a deemed transfer under Section 2519, taxpayers could consider the following:

- Trigger Section 2519 at a time when there is no trustee serving who has the power to make distributions to the beneficiary spouse[xxi];
- Do not have principal distributions made to the beneficiary spouse until a trustee has been appointed who had no knowledge of or involvement in the spouse's assignment of the income interest;
- If, at the time that the spouse assigns the income interest, there is a trustee who has the power to make principal distributions, do not inform the trustee of the assignment of the income interest until after the assignment has been made.
- Have the spouse write a contemporaneous letter or memorandum stating that he or she does not expect to receive or request principal distributions.

5. Disregarding a prior QTIP election.
In Rev. Proc. 2001-38, the IRS announced that it would permit a surviving spouse or his or her executors to disregard a QTIP election that was not necessary to reduce the first decedent's estate tax liability to zero. Although Rev. Proc. 2001-38 (to the extent it is still viable after the enactment of the "portability" provisions) requires a taxpayer to petition the IRS for such relief, some planners have speculated that the IRS may, on its own initiative, choose not to recognize a prior QTIP election. Ambiguous comments in PLR 201131011[xxii] are sometimes cited as support for this conclusion.

In PLR 201243004, the decedent created two trusts, one of which was described as a QTIP trust and the other as a "credit shelter trust." The term "credit shelter trust" may mean that the QTIP elections sought in the ruling were not "necessary" to reduce federal estate tax liability to zero. However, that interpretation is not certain: it is common, for example, for a "credit shelter trust" to be limited to the lesser of the federal and state estate tax exemption amounts. If that were the case with the credit shelter trust in PLR 201243004, it is possible that the QTIP elections that the taxpayer sought to make were, in fact, unnecessary to reduce federal estate tax to zero.

In any event, the IRS did not analyze whether the QTIP elections were required to be disregarded under Rev. Proc. 2001-38. The IRS's silence on "unnecessary" QTIP elections suggests that, consistent with Rev. Proc. 2001-38, a QTIP election will only be disregarded if the taxpayer actually seeks for it to be disregarded.

In Summary

By assigning an income interest in a QTIP trust, the beneficiary spouse can make a taxable gift of both income and principal yet retain access to the property that is deemed to have been transferred under Section 2519. The strategy was originally conceived as a way to use up the higher gift tax [xxiii] exemption amounts available through 2012.

Perhaps even more importantly, the strategy can greatly facilitate marital deduction planning and make it more tax-efficient, especially if Congress [xxiv] renews the new "portability" provisions. PLR 201243004 validates several premises of the strategy. In the authors' view, every estate planner should now add it to his or her standard planning "toolkit."

COMMENTS BY TECHNICAL EDITOR STEVE GORIN

If one wishes to plan for this technique, note the authors' suggestion that one not use ascertainable standards in one's QTIP trust so that the surviving spouse does not have enforceable rights to distributions. Also, I leave it up to you, our LISI readers, to consider whether there can be an implied understanding regarding principal distributions when the surviving spouse communicates with the trustee about surrendering the spouse's income interest.

To use this strategy, one must modify or eliminate a typical spendthrift clause. If one eliminates the spendthrift clause, then the trust will not provide the protection from creditors that is often desirable. Perhaps instead one might modify the spendthrift clause to authorize assignments from one beneficiary to another?

What if the spendthrift clause does not permit an assignment? Depending on state law, the surviving spouse might renounce his or her interest in the trust. Whether such a renunciation would accelerate the remaindermen's interest depends on the trust instrument and applicable state law.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Austin Bramwell
Vanessa Kanaga

TECHNICAL EDITOR: STEVE GORIN

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CITES:

Code §§ 2036, 2044(a), 2044(b)(2), 2056(b)(7), 2207A(b), 2519, 2652, 2702, 6110(k)(3); Treas. Reg. §§ 20.2036-1(c)(1)(i), 20.2056(b)-5(f)(7), 20.2056(b)-7(d)(1), 20.2056(b)-7(d)(2), 20.2056(b)-7(h) Example 1, 25.2207A-1(b)(1), 25.2207A-1(b)(2), 25.2511-2(c), 25.2519-1(a), 25.2519-1(g) Examples 3-5; Rev. Rul. 77-378; Rev. Proc. 2001-38, 2001-1 C.B. 1335; PLRs 200319002, 200328015, 200530014, 200944002, 201118014, 201119004, 201129017,

201131006, 201131011, 201144001; *Herzog v. Comm'r*, 116 F. 2d 591 (2d Cir. 1941), *Guynn v. U.S.*, 437 F.2d 1148 (4th Cir. 1971), *Maxwell v. Comm'r*, 3 F.3d 591 (2d Cir.1993), *Thompson v. Comm'r*, T.C. Memo 2002-246, aff'd 382 F.3d 367 (3rd Cir. 2004), *Estate of Strangi v. Comm'r*, T.C. Memo. 2003-145, aff'd, 96 AFTR2d 2005-5230 (5th Cir. 2005), *Korby v. Comm'r*, T.C. Memo 2005-103, aff'd 471 F.3d 848 (8th Cir. 2006), *Rosen v. Comm'r*, T.C. Memo 2006-115, *Bigelow v. Comm'r*, T.C. Memo 2005-65, aff'd 503 F.3d 955 (9th Cir. 2007), *Estate of Linderme v. Comm'r*, 52 T.C. 301 (1969), *Kerdolff v. Comm'r*, 57 T.C. 643 (1972), *Estate of Paxton v. Comm'r*, 86 T.C. 785 (1986), *Reichardt v. Comm'r*, 114 T.C. 144 (2000), *Estate of Rector*, T.C. Memo. 2007-367,Bramwell, "Using Section 2519 to Enhance Estate Planning," 38 *Estate Planning* 19-21 (October 2011), Bramwell and Kanaga, "The Section 2519 Portability Solution," *Trusts & Estates*, June 2012, Bramwell, "How to Use Portability to Avoid (Not Just Defer) State Death Tax," LISI Estate Planning Newsletter #1991 (July 24, 2012).

CITATIONS:

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[i] Bramwell and Kanaga, "The Section 2519 Portability Solution," *Trusts & Estates*, June 2012; Bramwell, "Using Section 2519 to Enhance Estate Planning," 38 *Estate Planning* 19-21 (October 2011); Bramwell, "How to Use Portability to Avoid (Not Just Defer) State Death Tax," **LISI** Estate Planning Newsletter #1991 (July 24, 2012).

[ii] IRC § 6110(k)(3).

[iii] The ruling does not provide any detail on the meaning of "insufficient" as the term was used in the trust instrument.

[iv] Section 2207A(b) provides that a transferor of a gift under Section 2519 is entitled to recover any gift tax paid which is attributable to such gift. Treas. Reg. § 25.2207A-1(b)(2) permits a written waiver of such right of recovery. Under Treas. Reg. § 25.2207A-1(b)(1), the failure to exercise the right of recovery is treated as a gift of the unrecovered amount when the right to recovery is no longer enforceable under applicable law and is treated as a gift even if recovery is impossible.

[v] The ruling does not explain why the taxpayer believed that his interests in the Exempt Trust and Trust 2 were required to be factored into the value of his gifts of Trust 1 property. Perhaps the taxpayer was concerned that the IRS might not recognize the division of the QTIP Trust for purposes of determining the property transferred under Section 2519 and, accordingly, he would have been deemed to have made a transfer of the Exempt Trust and Trust 2, while retaining an interest in those trusts to which Section 2702 would apply.

[vi] See, e.g., PLR 200319002.

[vii] Section 2519 causes a deemed transfer with respect to "any property" for which a QTIP marital deduction was allowed, even if only a part of a qualifying income interest for life was disposed of. Treas. Reg. § 25.2519-1(a). As "any property" could include all trusts created from the severance of a QTIP trust, severing a QTIP trust may not prevent Section 2519 from applying to the principal of all the resulting trusts.

[viii] See, e.g., PLRs 200328015, 200319002, 200530014, 201119004.

[ix] Given the ongoing uncertainty on this issue, cautious planners will continue to seek a letter ruling before advising taxpayers to sever a QTIP trust and trigger Section 2519.

[x]

Treas. Reg. § 20.2056(b)-7(d)(1).

[xi]

Treas. Reg. § 25.2519-1(g) Examples 3-5 assume that trusts qualified for the marital deduction despite that the spouse could assign the income interests. In addition, Treas. Reg. § 20.2056(b)-5(f)(7), incorporated into the QTIP requirements by Treas. Reg. § 20.2056(b)-7(d)(2)), expressly permits "spendthrift" clauses. If the presence of a spendthrift clause does not disqualify a trust for the marital deduction, then, *a fortiori*, neither should the absence of one. Finally, it is clear that a life estate can qualify as QTIP, even though it is a freely assignable property interest. Treas. Reg. § 20.2056(b)-7(h) Example 1. Income interests in trusts should likewise be assignable without jeopardizing the marital deduction.

[xii]

In Treas. Reg. § 25.2519-1(g) Example 5, the income beneficiary transferred a portion of the income interest but remained thereafter a discretionary beneficiary of principal. The example concludes that the deemed transfer under Section 2519 is a gift to which the valuation rules of section 2702 of the Code apply. As Section 2702 does not apply to incomplete gifts (see Section 2702(a)(3)(A)(i)), the example assumes that the deemed transfer is complete for gift tax purposes, notwithstanding the retained discretionary principal interest.

[xiii]

See, e.g., *Herzog v. Comm'r*, 116 F. 2d 591 (2d Cir. 1941); Rev. Rul. 77-378; PLR 200944002.

[xiv]

See PLR 200944002.

[xv]

IRC § 2044(b)(2).

[xvi]

As the taxpayer was the sole trustee of the QTIP trust, it may be that the trust instrument prohibited the taxpayer from participating in distribution decisions, such as under a standard "savings" clause, and required the appointment of an independent trustee in order to make distributions of principal to the taxpayer.

[xvii]

Treas. Reg. § 25.2511-2(c).

[xviii]

Treas. Reg. § 20.2036-1(c)(1)(i).

[xix]

See, e.g., PLR 200944002; 201118014; 201129017; 201131006; 201144001.

[xx]

See, e.g., *Estate of Linderme v. Comm'r*, 52 T.C. 301 (1969); *Guynn v. U.S.*, 437 F.2d 1148 (4th Cir. 1971); *Maxwell v. Comm'r*, 3 F.3d 591 (2d Cir.1993); *Reichardt v. Comm'r*, 114 T.C. 144 (2000); *Kerdolff v. Comm'r*, 57 T.C. 643 (1972); *Estate of Paxton v. Comm'r*, 86 T.C. 785 (1986); *Estate of Strangi v. Comm'r*, T.C. Memo. 2003-145, aff'd, 96 AFTR2d 2005-5230 (5th Cir. 2005); *Estate of Rector*, T.C. Memo. 2007-367; *Reichardt v. Comm'r*, 114 T.C. 144 (2000); *Estate of Reichardt*, 114 T.C. 144 (2000); *Thompson v. Comm'r*, T.C. Memo 2002-246, aff'd 382 F.3d 367 (3rd Cir. 2004); *Korby v. Comm'r*, T.C. Memo 2005-103; aff'd 471 F.3d 848 (8th Cir. 2006); *Rosen v. Comm'r*, T.C. Memo 2006-115; *Bigelow v. Comm'r*, T.C. Memo 2005-65, aff'd 503 F.3d 955 (9th Cir. 2007).

[xxi]

This may have been what the taxpayer did in PLR 201243004.

[xxii]

"In general, under Rev. Proc. 2001-38, 2001-1 C.B. 1335, a QTIP election under § 2056(b)(7) will be treated as null and void for purposes of §§ 2044(a), 2056(b)(7), 2519(a), and 2652, where the election was not necessary to reduce the estate tax liability to zero, based on values as finally determined for federal estate tax purposes."

[xxiii]

See Bramwell, "Using Section 2519 to Enhance Estate Planning," 38 *Estate Planning* 19-21 (October 2011).

[xxiv]

See Bramwell and Kanaga, "The Section 2519 Portability Solution," *Trusts & Estates*, June 2012; Bramwell, "How to Use Portability to Avoid (Not Just Defer) State Death Tax," **LISI** Estate Planning Newsletter #1991 (July 24, 2012).

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