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The IRS Just Confirmed That a QTIP Election Can Be Used With a Portability Election, Answering a Question That Has Existed Since 2010

By Loraine M. DiSalvo & Richard M. Morgan

The IRS recently answered a question that has existed for nearly six years now: whether Revenue Procedure 2001-38 would end up preventing the intentional use of a QTIP trust as part of planning aimed at using the new portability election to have a deceased spouse's Basic Exclusion Amount transferred to a surviving spouse. In December 2010, Section 2010(c) of the Internal Revenue Code ("IRC") was amended to create a new rule that allows the executor of a deceased married person's estate to file a federal estate tax return and make an election that allows the person's surviving spouse to use the deceased person's unused estate tax exemption, which is known as the Basic Exclusion Amount ("BEA"). The election created by this rule has become commonly known as the "portability" election, because the deceased spouse's remaining BEA is thought of as having become portable to the surviving spouse.

This rule opened a new set of options for couples whose combined assets exceeded the value of a single spouse's BEA (the BEA is $5,000,000, indexed for inflation since 2011; the BEA for 2016 is $5,450,000). Under the old rules, those couples were effectively forced to create a trust for the benefit of the surviving spouse at the first spouse's death, in order to ensure that the first spouse's estate tax exemption was not lost. Under the new rules, married couples who may need to be able to use both spouses' BEAs in order to avoid or reduce the impact of estate taxes on their estates now have the option to allow the first spouse's assets to pass to the surviving spouse outright, instead of using a trust for the surviving spouse. Many couples are deciding to use this option, to keep things as simple as possible for the survivor. Keeping things simple also has the potential benefit of allowing the first spouse's assets a second chance at an income tax basis step up at the surviving spouse's death, because the assets will be included in the surviving spouse's estate,[1] and the date of death values of those assets will then become the new basis used for determining capital gains or losses when the assets pass to the ultimate beneficiaries. A second basis step up can save the family significant income taxes. One disadvantage of using a trust for the surviving spouse to preserve the

[1] For purposes of calculating capital gains and losses when an asset is sold, it is important to know the seller's basis in that asset. In general, if someone purchases an asset, the initial basis will be the amount paid. Depending on the kind of asset, this initial basis may be increased or decreased over time. However, if the owner dies still owning the asset, and the asset is included in the owner's estate for estate tax purposes, the general rule is that the new owner who receives that asset as a result of the original owner's death takes a new income tax basis in the asset, instead of receiving the original owner's basis. The new basis is usually the value that was used when the asset was included for estate tax purposes in the original owner's estate. This can produce either an increased basis or a decreased basis, depending on whether the asset was worth more or less than the deceased owner's basis. However, because in many cases an increased basis results, the change in basis that results at an owner's death is often referred to as a "basis step up." If a surviving spouse receives assets from a deceased spouse outright, then those assets will receive a basis step up at the first death, and, if the surviving spouse still owns them at his or her own death, the assets will receive another basis step up. Assets that are owned by a trust which is includible in the trust beneficiary's estate at the beneficiary's death will receive a basis step up. However, if the trust's assets are not included in the beneficiary's estate at the beneficiary's death, then those assets will not receive any basis step up when the beneficiary dies.

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first spouse's BEA is that the chance for a second income tax basis step up will likely be lost, because the assets in the trust are not normally included in the surviving spouse's estate.

However, even if it is not necessary to use a trust for BEA preservation purposes, using a trust for the surviving spouse's benefit, instead of having all of the first spouse's assets pass to the surviving spouse outright, can still provide significant non-tax benefits. The potential benefits include providing creditor and predator protection for the spouse, providing protection against having the assets diverted to a new spouse if the surviving spouse remarries, and providing the first spouse's children with protection against being disinherited, which can be a particularly strong concern for those in blended families. These benefits are the reason that, in many cases, married couples still decide to use a trust for the surviving spouse's benefit at the first death, instead of having all assets pass outright to the surviving spouse at the first death. In these situations, the question of balancing the potential benefits of a second chance for an income tax step up at the surviving spouse's death with the benefits of using a trust for the spouse's benefit becomes very important.

There are different ways to obtain the benefits of using a trust for the surviving spouse while still preserving the opportunity to obtain a second basis step up at the surviving spouse's death. One such way is to have the assets from the first spouse pass to a special type of trust that can qualify for the marital deduction against estate taxes, and which will then be included in the surviving spouse's estate for estate tax purposes at his or her death. The most popular type of trust used for this purpose is called a "Qualified Terminable Interest Property" or "QTIP" trust.[2] A QTIP trust provides that the surviving spouse is the only beneficiary during his or her lifetime, and that all of the net income of the trust must be distributed outright to the surviving spouse at least once a year. If desired, the spouse can also be allowed to receive distributions of trust principal as needed. At the surviving spouse's death, the QTIP trust's terms control where the remaining trust assets end up, although the first spouse can give the surviving spouse some ability to modify that if desired. The QTIP trust is often referred to as a "QTIPable" trust, because the estate tax and income tax basis step up effects of the trust actually depend on whether or not a proper QTIP election is made for the trust at the first spouse's death. If a trust is a QTIP trust by design, but no proper QTIP election is made, then the assets held by the trust will not be included in the surviving spouse's estate at his or her death, and no second basis step up for the trust's assets will be available. However, if a proper QTIP election is made after the first spouse's death, then the assets held in a QTIP trust at the surviving spouse's death will be included in the surviving spouse's estate, and thereby become eligible for the second income tax basis step up.

[2] A QTIP trust is one which is structured in a manner that allows it to qualify for the Qualified Terminable Interest Property election. The QTIP election is the one which allows a QTIP trust for which the proper election is made to qualify for a marital deduction against estate taxes in the first spouse's estate. Unless the proper QTIP election is made, the assets that are placed in a QTIP trust do not qualify for a deduction against estate taxes in the first spouse's estate, and the QTIP trust will end up using some of the first spouse's BEA.

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In theory, a couple should be able to use a QTIP trust to provide protection for the surviving spouse and control over the ultimate distribution of the assets for the first spouse, while still receiving a second chance for a basis step up at the surviving spouse's death and relying primarily on the portability election to preserve the first spouse's BEA. Here is how the plan should work: The first spouse's estate planning documents provide for a QTIP trust to be created at his or her death, for the surviving spouse's benefit. Once the first spouse dies, the executor of the first spouse's estate must timely file a complete federal estate tax return, IRS Form 706, for the first spouse's estate. This will be necessary no matter what the value of the first spouse's estate actually is. On the estate tax return, the executor must make both (A) the QTIP election, for some portion or all of the QTIP trust, so that the portion for which the QTIP election is made qualifies for the marital deduction against estate taxes and does not use any of the first spouse's BEA; and (B) the portability election, so that the first spouse's unused BEA is transferred to the surviving spouse.

However, until very recently, there was a bug in this theoretical plan. In Revenue Procedure 2001-38, the Internal Revenue Service ("IRS") stated that it would disregard a QTIP election that was made on an estate tax return, if the QTIP election was not necessary to avoid an estate tax being due on the return. The position taken in this Revenue Procedure was actually a taxpayer-friendly ruling in 2001, because it prevented an accidentally made QTIP election from causing a trust created by a deceased spouse from being included in the surviving spouse's estate for estate tax purposes and potentially creating an estate tax liability when no estate tax benefit was gained from making the election in the deceased spouse's estate. Unfortunately, after the creation of the portability election, estate planners did not know whether the IRS would also apply Revenue Procedure 2001-38 in situations where the estate was not taxable, so that the QTIP election was not needed to reduce estate taxes, but where the QTIP election had been intentionally made to allow portability of the maximum amount of the first spouse's BEA along with the use of a trust for the surviving spouse, and to allow the trust's assets to be included in the surviving spouse's estate to get the income tax basis step up opportunity. In other words, would Revenue Procedure 2001-38 end up preventing the intentional use of a QTIP trust as part of the planning described above?

The IRS has now answered this question by issuing Revenue Procedure 2016-49. Effective as of September 27, 2016, the Revenue Procedure makes clear that a QTIP election and QTIP trust can be used along with a portability election, even in cases where the QTIP election was not needed to reduce or eliminate estate taxes at the first spouse' s death. To get to this result, the IRS limited the effect of Revenue Procedure 2001-38 so that it will cause a QTIP election to be ignored only for estates in which no portability election was made or deemed made by the executor. The IRS stated in Revenue Procedure 2016-49 that "Rev. Proc. 2001-38 was premised on the belief that an executor would never purposefully elect QTIP treatment for property if the election was not necessary to reduce the decedent's estate tax liability." Now that there are reasons why an executor might want to make a QTIP election in such cases, the IRS agreed that this option should be available, and ensures in Revenue Procedure 2016-49 that the option is clearly available. For an estate that may still

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want to disregard a QTIP election under Revenue Procedure 2001-38, the option to do so is also still available, under a modified set of requirements spelled out in Revenue Procedure 2016-49.

In issuing Revenue Procedure 2016-49, the IRS has answered a question that created uncertainty for many estate planners and their clients. While the technique of using a QTIP trust and a QTIP election, along with a portability election, is not right for all people,[3] it is nice to now be sure that it is available for those who wish to use it.

A copy of the new Revenue Procedure may be obtained from irs.gov: https://www.irs.gov/pub/irs-drop/rp-16-49.pdf

If you have questions about the planning techniques that may be right for you, please contact us at (678) 720-0750 or admin@morgandisalvo.com to schedule a no-cost, no-obligation estate planning consultation.

[3] In this newsletter, we have focused solely on the use of a QTIP trust for a surviving spouse, and we have focused primarily on the potential benefits associated with that use. However, QTIP trusts have some drawbacks, and there may be better options available for obtaining both protection and control over the trust's assets and still making a second basis step up available at the surviving spouse's death. Some of the potential drawbacks of a QTIP trust include: (A) the spouse can be the only beneficiary during his or her lifetime, meaning that none of the trust's assets can be used directly for the benefit of children, grandchildren, or other desired beneficiaries; (B) all of the trust's net income will be basically taxable income for the spouse, because it must all be paid to him or her outright, and there are no opportunities to shift some of the trust's taxable income to other beneficiaries who might be in a lower income tax bracket than the surviving spouse; (C) the requirement that all net income be distributed to the spouse outright reduces the protective benefits of the trust because, for example, it prevents the Trustee from being able to withhold that stream of income in cases where the surviving spouse may be being taken advantage of by a predatory third party, where the spouse may be subject to significant creditor claims, or where the spouse might otherwise be eligible for and need to receive needs-tested government benefits.