



A QTIP Trust Can Protect Your Children's Inheritance if You Remarry

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If you have children with someone other than your current spouse, you risk disinheriting them unless you plan properly. Consider the following example.

You are in your second marriage and you and your spouse each have adult children from prior marriages. If you die without a will or trust, most states' intestate laws provide for a nominal amount of your estate to first pass to your current spouse (in Utah, it is the first \$50,000). After that initial amount is paid, your remaining estate will be split between your current spouse and your children from your prior marriage. Again, this ratio varies from state to state (in Utah, one-half of the remaining assets would pass to your spouse and the other one-half would pass to your children).



If you and your spouse have executed wills which name each other as sole beneficiaries, your children will receive nothing at your death unless your spouse chooses to make a gift to them.

Now suppose following your death, your spouse remarries. If your surviving spouse were then to die without a will, his or her assets transfer under the same rules as above (remember, this now includes the assets you left your spouse at your death). The assets will transfer either to the new spouse and his or her children (not your children) under the state intestate law, or if a new will was executed in favor of the new spouse, entirely to the new spouse. Either way, your children are disinherited from either a substantial portion or all of the inheritance you may have intended for them to receive. This same result occurs if you and your spouse own property in joint tenancy with right of survivorship. Ownership of the property vests entirely in the surviving joint owner, possibly disinheriting your children altogether.

For most people, this paints a picture much different from what they would desire. On the one hand, you may want to preserve your spouse's standard of living by making all of your assets available for his or her lifetime. A transfer of nearly half your assets to your children at your death could have a substantial impact on your spouse's lifestyle. This is especially true if your main asset is the family home. In some circumstances, a forced sale of the home may be ordered. Additionally,

your children may be too young or immature to properly manage a significant inheritance upon your untimely death. However, you may ultimately want to leave all of your assets not consumed during your spouse's lifetime to your children upon your spouse's death.

One option is to rely on your spouse to honor your wishes and leave your assets to your children. The reality is that no matter how well-intentioned your spouse may be today with regard to passing your estate on to your children, people change their minds, change behaviors, and circumstances change. In addition, your spouse has his or her own children to consider. Through commingling, remarriage, and other life events, the separate identity of your assets may be lost and your children may be disinherited, either intentionally or unintentionally.

Fortunately, you do not have to choose between your spouse and your children. With proper estate planning, you will be able to provide for your spouse, yet ensure your children receive the inheritance you intend for them to receive.

QTIP TRUST TO THE RESCUE

The solution to this dilemma is making use of a properly drafted Qualified Terminable Interest Property Trust, commonly referred to as a QTIP Trust. This special type of trust is authorized under Internal Revenue Code Sections 2056(b)(7) and 2523(f).

Generally, to qualify for the marital deduction and avoid estate tax at your death, your property must pass to your spouse outright or in a trust where he or she has full access to the principal. A QTIP Trust is an exception to this general rule. A QTIP Trust allows you to separate your property into two portions: one portion is the interest or income the property can generate; the other portion is the property itself, called the corpus or principal. An example is an apartment building (corpus) that generates rental income (income). Another example is a portfolio of stocks and bonds (corpus) generating dividends and interest (income).

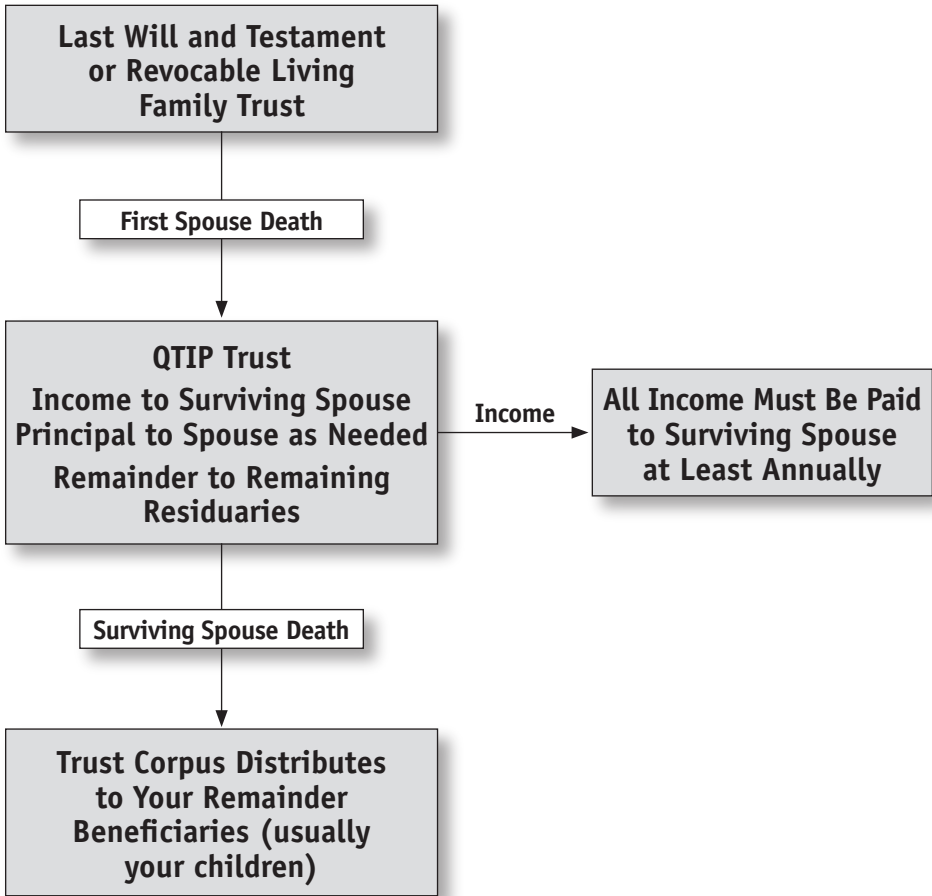
By separating your property into two portions, you can direct that each portion benefits a different person or group of people. So long as the QTIP Trust directs that all of the income will benefit your spouse during his or her lifetime, it will qualify for the marital deduction. That means the corpus can be preserved and distributed to the remainder beneficiaries, usually your children, following your spouse's death with no adverse estate tax consequences.

Properly drafted and executed, a QTIP Trust provides you with the following benefits:

1. The trust grants to your surviving spouse, during his or her lifetime, a "terminable interest" in the income portion of your assets. This interest in the income portion terminates at your spouse's death.
2. At your spouse's death, the corpus of the trust property passes to remainder beneficiaries you designate in the trust, typically your children from a prior marriage.

3. The trust “qualifies” for the unlimited marital deduction, rendering the assets in the QTIP trust exempt from estate taxes at your death.

The following flowchart illustrates how the QTIP works.



This type of trust is very powerful and commonly used in blended family situations. When either you or your spouse have children from a prior marriage, it is not uncommon for each spouse to have a bias in favor of his or her natural children over his or her step-children. Without a technique such as a QTIP Trust, your natural children may not receive the inheritance you intend.

While blended families are perhaps the most common scenario where a QTIP is put in place, any situation where you wish to protect principal, but allow interest to be accessed by your surviving spouse is a viable use for a QTIP. For example, if your spouse is a spendthrift or has creditor issues, you may want to protect the assets from his or her creditors or from frivolous spending habits. The same holds true if your spouse is an unsophisticated money manager or particularly vulnerable.

SIMPLE, YET TECHNICAL

QTIP Trusts have been used for years, if not decades. This strategy is by no means a cutting-edge strategy, nor overly complicated. The strategy is well known by qualified estate planning attorneys, but the technical requirements are strict. Also, the drafting attorney as well as the grantor (you) putting this strategy in place should have a very thorough understanding of the marital deduction and the potential estate tax liability of the particular estate being planned. The first step is to draft language in your current estate planning documents such as a last will and testament or a revocable living trust that directs a QTIP Trust be created at your death. To do this, your document may contain language similar to the following:

Qualified Terminable Interest Property

*I intend that the Marital Trust property shall constitute qualified terminable interest property for federal and state death tax purposes if and to the extent my Trustee or Personal Representative makes the necessary elections.
This agreement shall be interpreted to accomplish such intent.*

Termination of the Marital Trust at the Death of My Spouse

The Marital Trust shall terminate upon the death of my spouse.

Following your death, your estate plan will likely become irrevocable. Therefore, it is important that the provisions of the QTIP Trust be carefully considered. You will also want to carefully select the personal representative or trustee who will carry out the instructions, and appoint them in your trust. You must specify who the beneficiaries are, both the income beneficiary (remember, this must be your spouse for his or her lifetime) and the remainder beneficiaries. Finally, you should identify what property you would like to transfer into the QTIP Trust, or the formula your personal representative or trustee will follow when transferring property to your QTIP.

While putting in place language to allow for a QTIP election is relatively simple, deciding whether or not to elect QTIP treatment can be quite complicated.

POSTMORTEM QTIP ELECTION, ADMINISTRATION, AND PLANNING

Following your death, there is a limited time period for the personal representative of your estate or trustee of your trust to make an election for property to receive QTIP treatment. This election is made on IRS Form 706, the U.S. Estate and (Generation-Skipping Transfer) Tax Return, which must be filed no later than nine months following your date of death. Whether or not to make a QTIP election, thereby qualifying property for the marital deduction, is a fact-specific determination. The maximum estate tax rate is currently 45%; so depending on the size of your estate, the year of your death, and current law, this decision can have significant tax consequences.

Since an affirmative election must be made, this presents yet another opportunity for your heirs to examine the estate and take appropriate action. Your spouse and children may be at odds about making a QTIP election. Therefore, it is important that your personal representative or trustee know what goals are most important to you and that he or she consult with qualified tax counsel well before the nine month deadline to allow time for counsel to analyze the alternatives and make recommendations.

QTIP WRAPPED UP

What you should take away from this discussion is that if you are in a blended family situation where either you or your spouse has children from a prior marriage or relationship, your planning may not be as simple as the wills your neighbors have. Fortunately, the QTIP Trust is a simple solution which provides a customized estate plan for your unique family's goals and objectives.

Wilson Law Office PC practices in the areas of Estate and Business Planning, Elder Law and Medicaid Planning, and Trust Administration and Probate.