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ESTATE PLANNING MEMORANDUM

TO: CPAs, Clients & Associates

FROM: David L. Silverman, Esq.
Shirlee Aminoff, Esq.

DATE: April 2, 2010

RE: Modifying or “Decanting” Irrevocable Trusts

By making a QTIP election, the Executor will enable the decedent’s estate to claim a full marital deduction. To qualify, the trust must provide that the surviving spouse be entitled to all income, paid at least annually, and that no person may have the power, exercisable during the surviving spouse’s life, to appoint the property to anyone other than the surviving spouse. Since the Executor may request a 6 month extension for filing the estate tax return, the Executor in effect has 15 months in which to determine whether to make the QTIP election.

Nevertheless, electing QTIP treatment is not always advantageous. Inclusion of trust assets in the estate of the first spouse to die may “equalize” the estates. Equalization may have the effect of (i) utilizing the full exemption amount of the first spouse and (ii) avoiding higher rate brackets that apply to large estates. Still, the savings in estate taxes occasioned by reason of avoiding the highest tax brackets may itself be diminished by the time value of the money used to pay the estate

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tax at the first spouse's death. On the other hand, if the second spouse dies soon after the first, a credit under IRC §2013 may reduce the estate tax payable at the death of the surviving spouse.

Although the IRS had at one time litigated the issue, it now appears that the Executor may elect QTIP treatment for only a portion of the trust, with the nonelected portion passing to a credit shelter trust. If a partial QTIP election is anticipated, separating the trusts into one which is totally elected, and second which is totally nonelected, may be desirable. In this way, future spousal distributions could be made entirely from the elected trust, which would reduce the size of the surviving spouse's estate.

When the surviving spouse dies, QTIP property is included in her estate at the value at the date of her death. Her estate is entitled to be reimbursed for estate taxes paid by recipients of the trust property. The amount of reimbursement is calculated using the highest marginal estate tax brackets of the surviving spouse. The failure to seek reimbursement of estate taxes is treated as gift made to those persons who would have benefited from reimbursement. However, the failure by the estate of the surviving spouse to seek reimbursement will not be treated as a gift if the decedent's will provides that reimbursement will not be sought from QTIP property.

Care must be taken when making the QTIP election, since the IRS takes the position that if the election taken on the initial federal and state estate tax returns was defective — but the IRS did not notice the defect and allowed the marital deduction — the assets will nevertheless be includible in the estate of the surviving spouse under IRC §2044. Thus, the IRS takes the position that the assets are includible even if the estate of the first spouse would have incurred no estate tax had the QTIP election not been made. See PLR 9446001.

On the other hand, an unnecessary QTIP election will occasion of fewer harsh results. Under Rev. Proc. 2001-38, an unnecessary QTIP election for a credit shelter trust will be disregarded to the extent that it is not needed to eliminate estate tax at the death of the first spouse. Similarly, a mistaken overfunding of the QTIP trust will not cause inclusion of the overfunded amount in the estate of the surviving spouse. TAM 200223020.

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Since the estate tax is a “tax inclusive,” as opposed to the gift tax, which is “tax exclusive,” there is a distinct tax benefit to making lifetime, as opposed to testamentary, gratuitous transfers. A QTIP trust can assist in accomplishing this objective. Assume at a time when the applicable exclusion amount (AEA) is \$3.5 million, father has an estate of \$6 million, and mother has an estate of \$2.5 million. Father (who has made no lifetime gifts other than annual exclusion gifts) wishes to give his children \$4.5 million. If \$4.5 million were left to the children outright, the \$1 million excess over \$3.5 million would attract a federal estate tax of \$450,000, and a New York estate tax of \$160,000, for a total tax of \$610,000. This would leave only \$390,000 of the \$1 million bequest to the children. If instead of leaving \$4.5 million to his children outright, father were to leave only \$3.5 million to them, and place \$1 million in a trust qualifying for a QTIP election, many estate taxes could potentially be saved.

IRC §2519 provides that “any disposition of all or part of a qualifying income interest for life in any property to which this section applies is treated as a transfer of all interests in the property other than the qualifying income interest.” Therefore, were wife to gift one-half of her qualifying income interest, she would be deemed to have made a gift of the entire remainder interest in trust, in addition to the gift of the income interest. Under IRC §2207A(a), she would have a right to recover gift tax attributable to the deemed transfer of the remainder interest under IRC §2519.

Proposed regs provide for “net gift” treatment of the deemed gift of a remainder interest under IRC §2519. (A net gift occurs if the donee is required, as a condition to receiving the gift, that he pay any gift taxes associated with the gift.) The gift taxes so paid by the donee may be deducted from the value of the transferred property to determine the donor’s gift tax. Thus, assume the value of each of the income interest and the remainder interest in the QTIP trust are \$500,000. If wife makes a gift of one-half of her income interest, or \$250,000, she would be deemed to have made a net gift of the entire \$500,000 remainder interest. If the gift tax rate were 50%, wife would have made a net deemed gift of the remainder interest constituting \$333,333, resulting in a gift tax of \$167,667.

Although there must be no prearranged agreement that wife will make the contemplated

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transfer of her lifetime income interest, it is evident that the gift of a qualifying income interest in a QTIP trust can be an effective means of leveraging the \$3.5 million lifetime exemption amount by leaving assets to the surviving spouse, who is then expected — but not required — to make substantial gifts to the children. Note that in the example the intended result would not be accomplished if wife simply disclaimed her interest in the QTIP. In that case she would be treated as having predeceased her husband, and the \$1 million would again be paid to the children and subject to \$610,000 in combined federal and NYS tax.

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