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Summary of Qualified Terminable
Interest Property (“QTIP”) Trusts

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The federal estate tax is imposed on property owned by a person at the time of death. It is commonly referred to as a "tax-inclusive tax," as the tax is imposed upon the property itself, and only the property remaining after the tax is paid passes to the estate beneficiaries. The entire estate of a married person is not, however, subject to tax, because all property passing to the surviving spouse, either outright or in certain trust arrangements, will pass free from federal estate tax. Generally, for a trust to qualify for the marital deduction and thus be exempt from federal estate tax, the surviving spouse must have almost complete control over the trust and its ultimate disposition. Moreover, a terminable interest does not qualify for the marital deduction. A terminable interest is one that ends at some specified time. For example, a husband might leave his wife the use of a residence, but specify that the residence shall pass to the husband's children at the spouse's death. The value of the residence is thus a terminable interest and does not qualify for the marital deduction.

Congress has, however, carved out an exception to the terminable interest rule for property left to a surviving spouse in trust that meets the so-called QTIP rules. QTIP stands for "Qualified Terminable Interest Property." Thus, even though the property is left in a terminable interest, if it qualifies under certain rules a marital deduction will be available with respect to that property. For example, under the QTIP rules, a trust may qualify for the marital deduction even though the survivor's rights to the trust are restricted and the interests are terminable upon the surviving spouse's death.

In order to qualify as a QTIP trust, the surviving spouse must receive all of the income, and there must be a distribution of that income at least once a year. No one else can be entitled to receive any of the trust property during the surviving spouse's lifetime. At the time of the surviving spouse's death, the trust property will pass to persons named in the trust agreement, rather than as designated by the surviving spouse. Thus, the ultimate disposition of property left in a QTIP trust is not subject to the surviving spouse's discretion, but instead will pass only to those persons named in the trust agreement. For example, if property is transferred to the surviving spouse outright at the death of the first spouse, free of trust, the surviving spouse would be free to designate the ultimate recipient of the property, including a second spouse or non-relatives. Under the QTIP rules, at the surviving spouse's death, the trust property can pass to the children or issue of predeceased children, and the surviving spouse generally would not have the ability to cause the property to be distributed to anyone else. There is, therefore, assurance that the property will stay within the family, yet qualify for the marital deduction.

Although the surviving spouse's rights under a QTIP trust are limited, those limitations relate only to the ultimate disposition of the trust, and not to the rights of the surviving spouse to enjoy the benefits from the trust during his or her lifetime. Those benefits would include all of the income and a limited right to encroach upon the trust principal. The encroachment rights must, however, be subject to certain objective standards or the surviving spouse would be able to distribute all of the trust property to himself or herself.

Limiting the surviving spouse's "access" to trust principal through objective standards also provides protection from creditors. If the surviving spouse has the power to make discretionary principal distributions to himself or herself, a strong argument could be made that principal distributions might be forced by the surviving spouse's creditors because the surviving spouse has complete "access" to the trust principal.

A life-time or inter vivos QTIP trust, as opposed to a QTIP trust that is created at the time of death (testamentary QTIP trust), can be an effective tool to utilize the advantages of a QTIP trust, as described above, and to fully utilize both spouses' estate tax exemptions.

For example, if a Husband has assets of $9,000,000.00, and his Wife has assets of $1,000,000.00, and Wife predeceases Husband, the Wife's estate will only be able to use $1,000,000.00 of her $5,000,000.00 estate tax exemption (assuming the estate tax exemption amount is $5,000,000.00, and Congress has failed to extend the availability of portability of exemption between spouses). In order equalize the Husband's and Wife's estates, and to ensure that both of their individual exemption amounts will be fully utilized at death, Husband could during his lifetime transfer outright $4,000,000.00 to his Wife, resulting in both the Husband and his Wife having assets of $5,000,000.00 (equal to the current estate tax exemption amount).

The solution described in the previous paragraph, however, is not ideal in the case of a second marriage or if the spouse with the greater assets does not wish to give the other spouse absolute and total control over the transferred property.

An alternative solution is the creation of a life-time or inter vivos QTIP trust. Creating a life-time or inter vivos QTIP trust for the benefit of one's spouse can be used to ensure that both spouses' estate tax exemptions will be fully utilized regardless of the order of deaths, and at the same time allow for the transferor spouse to transfer assets to the transferee spouse, in trust, under the same distribution provisions and restrictions of a testamentary QTIP trust, and satisfy the QTIP requirements (as described earlier in this memorandum). The assets transferred by the transferor spouse to the inter vivos QTIP trust will be included, for estate tax purposes, as a part of the transferee spouse's estate, which, if structured correctly should result in the equalization of the two spouses' estates, and, consequently, the full utilization of both spouses' estate tax exemptions.

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