[Missouri Law Review](https://scholarship.law.missouri.edu/mlr)

Volume 49
Issue 4 *Fall 1984*

Article 3

Fall 1984

Marital Trust v. QTIP: Advice for Estate Planners

George M. Schain

MARITAL TRUST v. QTIP: ADVICE FOR ESTATE PLANNERS

GEORGE M. SCHAIN*

I. INTRODUCTION

The Economic Recovery Tax Act of 1981[1] drastically altered the Federal Estate and Gift Tax marital deduction.[2] The most notable change was the complete abolition of any ceiling on the amount of qualifying property which could be claimed as a marital deduction.[3] The Act also designated a new class of property qualifying for the marital deduction called Qualified Terminable Interest Property (QTIP) for which the donor or decedent's executor may elect to claim the marital deduction even though certain rights are not given to the surviving spouse.[4] This provision was intended to allow the donor or decedent to plan for the proper disposition of his property, unfettered by the fear of transfer tax consequences.[5] In so doing, the Act created more flexibility for

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* Associate Professor of Law, New York Law School; A.B., New York University, 1955; J.D., Fordham University, 1958.

1. The Economic Recovery Tax Act of 1981 [hereinafter cited as ERTA], Pub. L. No. 95-34, 97 Stat. 172 (1981) (codified as amended in scattered sections of 26 U.S.C. (1982)).

2. ERTA § 403 (codified as amended at I.R.C. § 2056 (1982)).

3. *Id.* § 403(a), (d) (codified as amended at I.R.C. § 2056 (1982)).

4. *Id.* § 403(d)(1) (codified as amended at I.R.C. § 2056(b)(7) (1982)).

5. H.R. REP. NO. 201, 97th Cong., 1st Sess. 159 (1981), *reprinted in* 1981-2 C.B. 352.

The Committee Report expressly voiced a concern that a decedent would be both pre- and post-mortem estate planning.[6]

Prior to ERTA the value of certain terminable interests (known as nondeductible terminable interests) transferred to a spouse was nondeductible.[7] This general rule, however, was subject to three specific exceptions, the most important of which for our purposes is the life estate with a general power of appointment in the donee.[8] The common thread to the recognized exceptions was the total relinquishment of control by the donor or decedent.[9] QTIP, however, permits the decedent to transfer a mere life interest to the spouse and *retain complete control over the ultimate disposition of the property without forfeiting the marital deduction.*[10] This makes the QTIP an extremely attractive device for estate planners.

The present article briefly traces the history of the marital deduction and outlines the use of the marital or *"A"* trust as a background to aid in more fully understanding the QTIP. The article then describes the QTIP provisions (including the recapture provisions) in detail. Finally, the article discusses the possible estate planning uses of the QTIP and offers an example designed to illustrate some of the difficulties which may be encountered in a typical QTIP situation. For purposes of simplicity, the scope of this article is primarily limited to the QTIP as applied to the estate tax. Differences in application of the QTIP to the gift tax will be noted where appropriate.

"forced to choose between surrendering control of the entire estate at his death or reducing his tax benefits at his death to insure inheritance to his children." *Id.*

6. *See generally* Gingiss, *Marital Deduction Planning Under ERTA '81*, 60 TAXES 269 (1982).

7. I.R.C. § 2056(b)(1) (1982). The general rule states that "[w]here, on the lapse of time, or the occurrence of an event or contingency, or on the failure of an event or contingency to occur, an interest passing to the surviving spouse will terminate or fail, no deduction shall be allowed . . . ." *Id.*; *see infra* notes 35-39 and accompanying text.

8. The first exception is where the interest of the spouse is conditioned on survival for a limited period. I.R.C. § 2056(b)(3) (1982). See *infra* notes 40-43 and accompanying text for a discussion of this exception.

The second exception is for certain life insurance or annuity payments where the surviving spouse has a power of appointment. I.R.C. § 2056(b)(6) (1982); *see infra* note 44 and accompanying text.

The third exception is for the life estate with a general power of appointment in the spouse. I.R.C. § 2056(b)(5) (1982); *see infra* notes 45-77 and accompanying text.

9. The survivorship exception applies only when the interest vests absolutely in the surviving spouse but is defeasible in the event that the death of the surviving spouse closely follows that of the decedent. I.R.C. § 2056(b)(3) (1982). The other two exceptions require that the surviving spouse have a general power of appointment which may be exercised to convert the nondeductible terminable interest to a deductible terminable interest. *Id.* § 2056(b)(5), (6).

10. *Id.* § 2056(b)(7); *see* H.R. REP. No. 201, 97th Cong., 1st Sess. (1981), *reprinted in* 1981-2 C.B. 352, 378-79.

II. A Brief History

Congress first imposed an estate tax in 1916.[11] The purpose of the tax was, and still is, to prevent vast private accumulations of wealth which could be passed from generation to generation without ever becoming subject to taxation.[12] As originally enacted, the estate tax did not provide any marital deduction for property which passed to the decedent's spouse.[13] This omission, however, resulted in an inequitable system of taxation between citizens of common law and community property states.[14]

In effect, the estate of the first spouse to die in a community property state was automatically provided with a marital deduction equal to approximately fifty percent of the entire estate.[15] This was true because, under the community property laws, fifty percent of the marital property was deemed to have already belonged to the surviving spouse and therefore could not be included in the decedent's estate.[16] As a result, residents of community property states enjoyed a significant estate tax advantage.[17]

Congress first sought to eradicate this inequity in 1942 by providing that the taxable estate included the full value of the community property owned by the decedent and the decedent's spouse.[18] Prior to 1942, as we have seen, the estate included only that portion of the community property attributable to the decedent.[19] Under the 1942 law, the decedent's estate was also taxed on property which the decedent did not own and over which he could exercise no power of disposition.[20] Thus, the law created a seemingly anomalous situation whereby a community property state decedent was required to pay tax on property which was, and under state law always had been, wholly owned and

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11. Revenue Act of 1916, Pub. L. No. 64-271, 39 Stat. 756, 777 (1916).

12. *See* United States v. Stapf, 375 U.S. 118 (1963).

13. *See generally* R. Stephens, G. Maxfield & S. Lind, Federal Estate and Gift Taxation § 5.06[5][a] (4th ed. 1978).

14. *Id.* The advantage was the result of the fact that only one half of the value of community property owned by the decedent and his spouse is included in the estate. See Treas. Reg. § 20.2056(c), T.D. 6296, 1958-2 C.B. 432, for the rules governing the calculation of the appropriate marital deduction. The reader should note that former I.R.C. § 2056 has been repealed. ERTA § 403(a)(1)(A). The community property states are Louisiana, California, Arizona, Nevada, Texas, Washington, Idaho, and New Mexico.

15. *See* R. Stephens, G. Maxfield & S. Lind, *supra* note 13, § 5.06[1]. Since 50% of the value of the community property was never included in the estate, it was never subject to taxation. The result is the same as if the full value were originally included in the gross estate, and the estate were permitted a 50% deduction.

16. *Id.* This result depends on the application of local law. Hernandez v. Becker, 54 F.2d 542, 599 (10th Cir. 1931); *cf.* Rev. Rul. 284, 1974-1 C.B. 276.

17. R. Stephens, G. Maxfield & S. Lind, *supra* note 13, § 5.06[5][a].

18. Revenue Act of 1942, Pub. L. No. 77-753, § 811(e)(2), 56 Stat. 798 (1942).

19. *See supra* notes 14-17 and accompanying text.

20. Revenue Act of 1942, § 402(b). The decedent was prohibited from disposing of the full value of community property by provisions of local law.

controlled by another person. The law was, however, upheld by the Supreme Court.[21]

Soon after the Supreme Court decision, however, Congress abandoned the 1942 approach in favor of a marital deduction for non-community property.[22] In 1948 Congress set the estate tax marital deduction as the lesser of the qualifying property passing to the spouse or one half of the adjusted gross estate.[23] The marital deduction remained unchanged until 1977 when it was amended to reduce the burden on smaller estates by providing for a possible minimum $250,000 deduction.[24]

As enacted by Congress, the marital deduction was available only for qualifying property passing to the surviving spouse.[25] To be deemed qualifying property passing to the spouse, all five of the following requirements must be met: (1) the decedent must have been either a United States citizen, or a United States resident at death;[26] (2) the decedent must have been survived by a spouse;[27] (3) the property interest must have passed from the decedent to the

21. Fernandez v. Wiener, 326 U.S. 340 (1945).

22. Revenue Act of 1948, Pub. L. No. 80-471, 62 Stat. 117 (1948). Commenting on the purpose of the marital deduction, Justice Goldberg stated:

> The 1948 tax amendments were intended to equalize the effect of the estate taxes in community property and common-law jurisdictions. Under a community property system . . . the spouse receives outright ownership of one-half of the community property and only the other one-half is included in the decedent's estate. To equalize the incidence of progressively scaled estate taxes and to adhere to the patterns of the law, the marital deduction permits a deceased spouse . . . to transfer free of taxes, one-half of the non-community property to the surviving spouse. Although applicable to separately held property in a community property state, the primary thrust of this is to extend to taxpayers in common law States the advantages of "estate splitting" otherwise available only in community property States.

United States v. Stapf, 375 U.S. 118, 128 (1963).

23. Revenue Act of 1948, Pub. L. No. 80-471, 62 Stat. 110, 117 (1948).

24. Tax Reform Act of 1976, Pub. L. No. 94-455, § 2009(b)(4)(E), (e)(2), 90 Stat. 1520 (1976). This rule does not apply to estates of decedents dying after December 31, 1981. ERTA § 403(a)(1)(B) (1981).

25. I.R.C. § 2056(a) (1982); Treas. Reg. § 20.2056(a)-1, (b)-5, (d)-1, (e)-1, (e)-2, (e)-3 (1984).

26. The regulations provide that:

> Except as provided by a death tax convention with a foreign country, the marital deduction is not allowed in the case of an estate of a nonresident who was not a citizen of the United States at the time of his death. However, if the decedent was a citizen or resident, his estate is not deprived of the right to the marital deduction by reason of the fact that his surviving spouse was neither a resident nor a citizen.

Treas. Reg. § 20.2056(a)-1 (1984). Thus, in the absence of a treaty provision to the contrary, the decedent must be either a United States citizen or resident to qualify for the marital deduction.

27. Treas. Reg. § 20.2056(a)-1(b)(1) (1984). If the order of death cannot be determined, a presumption supplied by local law or a provision of the decedent's will that the decedent was survived by a spouse will satisfy this requirement. *Id.* § 2056(e)-2(e).

spouse;[28] (4) the property interest must have been a deductible interest; [29] and (5) the property interest must not be a nondeductible terminable interest unless it comes within one of the three exceptions to the nondeductible terminable interest rule.[30] The three exceptions to the nondeductible terminable interest rule are the survivorship, the life estate general power of appointment, and the life insurance general power of appointment.[31] For our purposes, the life estate general power of appointment is the most important of these exceptions because of its similarity to the QTIP.

Of the five requirements for qualifying property passing to the spouse, the first two, that the decedent must have been a United States citizen or resident at death and survived by a spouse, are largely self-explanatory and straightforward in their application.[32] The operative definition of property which passes from the decedent to the spouse is somewhat more complicated and may include property interests which vest in the surviving spouse by such diverse means as intestate succession, by will, through a will contest, by dower, by curtesy, by right of election, by joint ownership, by lifetime transfer, by insurance, by default of the exercise of a power, and by an effective disclaimer of a third party.[33] The fourth requirement, that the interest must be a deductible interest, appears initially to lead only to the circuitous conclusion that an interest must be deductible to be deductible. The paradox is simply resolved, however, by application of the general rule that all interests are deductible unless specifically made nondeductible in the regulations.[34]

III. The Terminable Interest Rule

The final requirement for the marital deduction is that the property which passes to the surviving spouse must not be a nondeductible terminable interest.[35] A terminable interest is one which will fail or terminate upon the lapse

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28. The definition of "passed from the decedent" is set forth in the regulations. *Id.* § 20.2056(e)-1. Special rules are provided for life interests, insurance, or annuity proceeds where the spouse has a power of appointment, disclaimers, elections, and will controversies. *Id.* § 20.2056(e)-2.

29. An interest passing to the decedent's surviving spouse is deductible unless: (1) it is not included in the decedent's estate; (2) a deduction is allowed under § 2053 for expenses and indebtedness; (3) a deduction is allowed under § 2054 for a loss during settlement of the estate; or (4) it is a nondeductible terminable interest. *Id.* § 20.2056(a)-2.

30. *Id.* § 20.2056(a)-2(b)(4).

31. I.R.C. § 2056(b)(3), (5), (6).

32. Treas. Reg. § 20.2056(a)-1 (1984); *see supra* notes 26-27.

33. Treas. Reg. § 20.2056(e)-2 (1984); *see supra* note 28.

34. Treas. Reg. § 20.2056(a)-2(b) (1984). "An interest passing to a decedent's surviving spouse is a 'deductible interest' if it does not fall within one of the . . . categories of 'nondeductible interests.'" *Id.* The nondeductible interests are set forth in note 29 *supra.*

35. *Id.* § 20.2056(b)-1. If no person may possess or enjoy the property following the termination of the spouse's interest without payment of full and adequate consider-

of time or upon the occurrence or nonoccurrence of a specified event.[36] In order to be a nondeductible terminable interest, the interest must then pass to another person who received his interest from the decedent for less than adequate and full consideration.[37] Whether the spouse has received a terminable interest must be determined at the date of the decedent's death.[38] Interests which are subject to termination upon a condition subsequent are deemed terminable for tax purposes irrespective of whether the subsequent condition is ever fulfilled.[39]

The first exception to the nondeductible terminable interest rule is the survivorship exception. This exception was enacted to permit decedents to pass their property to others if the surviving spouse should die shortly after the decedent. The Code provides that an interest left to the surviving spouse will not be considered a terminable interest if it will terminate only if the death of the surviving spouse occurs within six months of the decedent or as a result of a common disaster *and* such termination does not occur.[40] This rule is necessary to prevent an unjustly mechanical application of the rule that the nature of the interest received by the spouse is to be determined at the death of the decedent.

To qualify for the survivorship exception it is essential that the will be carefully drafted. If the designated survival condition is any longer than six months the interest which passes to the spouse will generally be nondeductible.[41] A properly drafted common disaster clause, however, may preserve the marital deduction even though the spouse survives the other spouse by more than six months if the death of the spouse is a result of the common disaster.[42] The result is possible if the designated survival period and the common disaster clause are connected by a disjunctive, i.e., "or."[43]

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ation, the interest is a deductible terminable interest. Thus, if the property either will terminate without passing to any other person or will pass only upon payment of full and adequate consideration, the interest will be deductible. An example of this type of interest is a copyright that is bequeathed to the spouse but will expire at a time certain following the death of the deceased author donor.

36. I.R.C. § 2056(b)(1); Treas. Reg. § 20.2056(b)-1(b) (1984).

37. *Id.* I.R.C. § 2056(b)(1)(A); Treas. Reg. § 20.2056(b)-1(c)(i) (1984); *see supra* note 35.

38. Treas. Reg. § 20.2056(b)-1.

39. *Id.* at (g), Example (2).

40. I.R.C. § 2056(b)(3); Treas. Reg. § 20.2056(b)-3 (1984).

41. I.R.C. § 2056(b)(3); Treas Reg. § 20.2056(b)-3 (1984). "If the condition (unless it relates to death as a result of a common disaster) is one which may occur either within the 6-month period or thereafter," the survivorship exception is unavailable. Treas. Reg. § 20.2056(b)-3(b) (1984).

42. Treas. Reg. § 20.2056(b)-3(c) (1984). If the property interest is subject to the condition that the spouse not die as the result of a common disaster, the application of the survivorship exception depends on the operation of the common disaster provision under local law. *Id.*

43. *Id.* § 20.2056(b)-3(d). *Compare id.* at Example (2) (decedent bequeathing estate to niece if decedent and spouse both die in a common disaster *or* if spouse fails

There is also an exception to the nondeductible terminable interest rule for proceeds from a life insurance policy, endowment, or annuity payable to the surviving spouse if the surviving spouse has a general power of appointment over such proceeds.[44] This exception was enacted to aid the surviving spouse by providing effective management of the decedent's life insurance and annuity interests. In this way the proceeds can be paid to the surviving spouse periodically and certain beneficial options under the policy may be available. This exception is very similar to the life estate general power of appointment exception.

The life estate general power of appointment exception is the most important exception to the nondeductible terminable interest rule for our purposes. A thorough understanding of this exception and its application is critical to a proper understanding of QTIP. A life estate which passes to the surviving spouse will qualify for this exception only if all the statutory requirements are met.[45] The regulations list five requirements, two of which deal with the income rights of the surviving spouse and three of which govern the nature of the power of appointment.[46] The rigidly mechanistic application of these requirements has spawned much litigation. Indeed, the Supreme Court has observed that "the achievement of the purposes of the marital deduction is dependent to a great degree upon the careful drafting of wills."[47]

The first requirement is that the surviving spouse must be entitled to all of the income from the property, all of the income from a specific portion of the property, or a specific portion of all the income.[48] The regulations require that all segregated portions, whether of the property interest itself or of the income derived therefrom, be expressed in terms of a fraction or percentage. The regulations explicitly exclude any annuity or other periodically disbursed interest which is expressed in terms of a dollar amount.[49] The Supreme Court

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to survive decedent by three months) *with id.* at Example (3) (decedent bequeathing estate to niece if decedent and spouse both die in a common disaster *and* if spouse fails to survive decedent by three months). In both Examples (2) and (3) a deductible interest passes to the spouse upon nonoccurrence of the events.

44. I.R.C. § 2056(b)(6) (1982); Treas. Reg. § 20.2056(b)-6 (1984).

45. I.R.C. § 2056(b)(5) (1982); Treas. Reg. § 20.2056(b)-5(a) (1984).

46. Treas. Reg. § 20.2056(b)-5(a) (1984). The five requirements are that: (1) the surviving spouse must be entitled to all the income from the entire interest or a specific portion thereof, or a specific portion of all the income from the entire interest; (2) the income must be payable at least annually; (3) the surviving spouse must have the power to appoint the entire interest or a specific portion to herself or her estate; (4) there can be virtually no limitations on the surviving spouse's exercise of the power; and (5) no person other than the spouse may have a power to appoint away from the spouse. *Id.*

47. Jackson v. United States, 376 U.S. 503, 511 (1964).

48. Treas. Reg. § 20.2056(b)-5(a), (b), (c), (f).

49. *Id.* § 20.2056(b)-5(c).

> A partial interest in property is not treated as a specific portion of the entire interest unless the rights of the surviving spouse . . . constitute a fractional or percentile share of a property interest so that such interest or share . . . re-

has rejected this harsh construction, however, by ruling that a specific and ascertainable dollar amount shall be considered a "specific portion" of the income for purposes of this exception.[50] This ruling is of major importance for estate tax lawyers because death benefits are very often payable in periodic payments of specified dollar amounts.

The second requirement is that income must be payable annually or more frequently.[51] Thus, if the property interest is non-income producing, the marital deduction is in jeopardy unless the surviving spouse can compel conversion or exchange of the unproductive property for income producing property.[52] The marital deduction will also be lost if the property is held in trust, and the distribution of the income is subject to the discretion of the trustee because the surviving spouse is not *entitled* to the income annually or more frequently.[53] The surviving spouse's personal use of a residence is deemed the equivalent of income received.[54]

The third requirement is that the surviving spouse have a power to appoint to herself or her estate.[55] This power must be over the entire interest or a specific portion.[56] A recent case extended the rationale of the Supreme Court in *Northeastern Pennsylvania Bank and Trust v. United States*[57] to invalidate the "specific portion" requirement in the case of corpus.[58]

However, it is not necessary under the regulations that the spouse be given a testamentary power to appoint any assets which have not been disbursed prior to the death of the surviving spouse so long as she has an inter vivos general power of appointment.[59] Thus a life estate coupled with an inter

> flects its proportionate share of the increment or decline in the whole of the property interest to which the income rights and the power relate . . . . On the other hand, if the annual income of the spouse is limited to a specific sum, or if she has a power to appoint only a specific sum out of a larger fund, the interest is not a deductible interest.

Id.

50. Northeastern Penn. Nat'l Bank & Trust v. United States, 387 U.S. 214 (1967). The Commissioner has proposed an amendment to the regulation which conforms to the *Northeastern* case. Prop. Reg. § 20.2056(b)-5(c)(3), 1984-25 I.R.B. 15, 21.

51. Treas. Reg. § 20.2056(b)-5(a)(2), (f)(8), (f)(9) (1984).

52. *Id.*

53. *Id.*

54. *Id.* § 20.2056(b)-5(f)(3). "[A] power to retain a residence or other property for the personal use of the spouse will not disqualify the interest passing in trust." *Id.*

55. *Id.* § 20.2056(b)-5(a)(3), (g).

56. *Id.* "The power of the surviving spouse must be a power to appoint the entire interest or a specific portion of it as unqualified owner." *Id.* § 20.2056(b)-5(g)(2).

57. 387 U.S. 213 (1967).

58. Estate of Alexander v. Commissioner, 82 T.C. 34 (1984).

59. Treas. Reg. § 20.2056(b)-5(g)(5) (1984). *But see* Estate of Pipe v. Commissioner, 241 F.2d 210 (2nd Cir.) (denying the deduction in the absence of a testamentary power), *cert. denied*, 355 U.S. 814 (1957). This case, which appears to be more stringent than the regulation, also appears to be an aberration. However, to avoid

vivos general power of appointment which expires at the death of the surviving spouse will qualify for the marital deduction even though the spouse has no power over the unexpended portion of the interest.[60]

The fourth requirement is that the power must be exercisable by the surviving spouse alone and exercisable in all events.[61] Thus, if the joinder or consent of any other person is required to exercise the power, the interest will not qualify for the marital deduction.[62] Similarly, if the exercise of the power is subject to a condition precedent or may be extinguished by a condition subsequent, the requirements for the marital deduction are not met.[63] However, if the right to exercise the power can be extinguished only by the death of the surviving spouse because the spouse has not been given a testamentary power of disposition, the regulations indicate that the interest is deductible.[64]

The final requirement is that the interest, or the specific portion thereof for which the deduction is sought, must not be subject to a power in any other person to appoint away from the spouse.[65] To disqualify the interest for the marital deduction, the power must be adverse to that of the surviving spouse.[66] A power to distribute corpus or additional income to the spouse or to enable the spouse to meet a legally imposed obligation will not disqualify the deduction.[67] If the power to appoint away from the spouse governs only a specific portion of the corpus, that portion not subject to the power will qualify for the marital deduction.[68]

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a possible disallowance of the marital deduction, it would be wise to spell out the spouse's unlimited power to invade.

60. Treas. Reg. § 20.2056(b)-5(g) (1984).

61. *Id.* § 20.2056(b)-5(g)(3).

> A power is not considered to be a power exercisable by a surviving spouse alone and in all events as required . . . if the exercise of the power . . . requires the joinder or consent of any other person . . . . In order for a power of invasion to be exercisable in all events, the surviving spouse must have the unrestricted power exercisable at any time during her life to use all or any part of the property subject to the power, and to dispose of it in any manner, including the power to dispose of it by gift (whether or not she has the power to dispose of it by will).

Id.

62. *Id.*

63. *Id.* "For example, a power which is not exercisable in the event of the spouse's remarriage is not exercisable in all events." *Id.*

64. *Id.* § 20.2056(b)-5(g)(3), (5); *see supra* note 59.

65. I.R.C. § 2056(b)(5) (1982); Treas. Reg. § 20.2056(b)-5(j) (1984).

66. Treas. Reg. § 20.2056(b)-5(j) (1984) "[O]nly powers in other persons which are in opposition to that of the surviving spouse will cause a portion of the interest to fail to satisfy the condition set forth in paragraph (a)(5) of this section." *Id.*

67. *Id.* "[A] power to distribute corpus to the spouse for the support of minor children will not disqualify the trust if she is legally obligated to support such children." *Id.*

68. *Id.* at Example (2).

IV. Use of the Life Estate General Power of Appointment in Estate Planning

In most cases, estate planning is utilized to minimize the tax which will be imposed on the aggregate assets of a married couple. Thus, one of the primary objectives of much estate planning is to equalize the value of the adjusted gross estate for each spouse individually, in order to minimize the aggregate tax liability of the couple.[69] The life estate general power of appointment exception to the nondeductible terminable interest rule is a powerful tool for estate planners attempting to accomplish this objective.

The most common plan employed to minimize aggregate tax liability for the couple involves dividing the estate of the decedent spouse into two separate trusts.[70] One of the trusts, termed either the *"A"* trust or the marital trust, is designed to meet all of the requirements of the life estate general power of appointment exception to the nondeductible terminable interest rule.[71] Thus, any assets which are in the marital, or *"A"*, trust qualify as a marital deduction to the estate of the decedent spouse.[72] The second trust, termed the *"B"* trust or the non-marital trust, lacks one or more of the requirements of the life estate general power of appointment exception.[73] Quite often the missing requirement is the power to appoint the corpus to the surviving spouse or estate, thus enabling the decedent spouse to provide support for the surviving spouse yet retain control of the ultimate disposition of the property.[74] The assets in the *B* trust do not qualify for the marital deduction.[75]

The respective sizes of the *A* and *B* trusts are generally not explicitly designated by the testamentary instrument. Instead, the testamentary instrument usually contains a formula clause to determine the size of the *A* trust.[76] Although some formula clauses are more elegant than others and careful drafting is essential, the basic function of the clause is to channel sufficient assets to the *A* trust to provide the estate with the maximum marital deduction permitted by the tax law in effect at the time of death.[77] All assets which do not go into the *A* trust and are not the subject of specific bequests fall into

69. *See generally* Gingiss, *supra* note 6.

70. *See* Bishop & McKinney, *1981 Tax Act—Mandatory Will Review*, CASE & COM., July-Aug 1982, at 38, 42.

> The standard practice was to set up an "A" trust, which typically would have provided income and a testamentary power of appointment to W and a "B" trust which gave W only an income interest. The formula reproduced made the "A" portion as large as it had to be to minimize taxes at H's death, but no larger since the "A" trust would be taxable at W's death.

Id.

71. *Id.*

72. *Id.* at 42-43.

73. *See id.*

74. *See id.*

75. *Id.* at 43.

76. *Id.* at 41.

77. *Id.*

the *B* trust.

V. QTIP

In 1981, Congress lifted the ceiling from the marital deduction by providing for an unlimited marital deduction for interspousal transfers of qualifying property for 1982 and subsequent years.[78] At that time, Congress expressed concern that the availability of a potentially unlimited estate tax deduction would induce testators to leave their entire estate to their surviving spouse even in situations where such a disposition would be unwise.[79] Therefore, Congress adopted a beneficial enjoyment rule designed to permit the testator to plan for the proper disposition of property unfettered by the fear of transfer tax consequences.[80] At the same time, however, Congress provided that any property which escaped taxation as a result of the beneficial enjoyment rule would be subject to taxation at the time of disposition by the transferee spouse.[81] Then, in an effort to avoid imposing an unjust tax burden for property over which the transferee spouse can exercise no control, Congress provided the transferee spouse with a right to recoup any additional tax burden from the ultimate beneficiary.[82] The effect of these provisions is closely interrelated and they must always be considered in conjunction with each other. Together they form the basic framework of Qualified Terminable Interest Property, a new and vastly more flexible exception to the nondeductible terminable interest rule.

The exception for qualified terminable interest property was the outgrowth of American Law Institute (ALI) proposals for an unlimited marital deduction which were first proposed to Congress prior to the Tax Reform Act of 1976.[83] The ALI proposal advocated replacing the terminable interest rule with a rule apportioning tax liability, or eligibility for a deduction, according to current beneficial enjoyment.[84] In its original form, the ALI proposal provided a marital deduction for every transfer resulting in current beneficial enjoyment by the surviving spouse. Under the ALI proposal, the marital deduction would have been available whether the beneficial enjoyment was for the life of the spouse, a term of years, or any other period of time, determinate or

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78. ERTA § 403(a), (d) (codified as amended at I.R.C. § 2056 (1982)).

79. H.R. REP. No. 201, 97th Cong., 1st Sess. (1981), *reprinted in* 1981-2 C.B. 352.

80. ERTA § 403(d)(1) (codified as amended at I.R.C. § 2056(b)(7) (1982)). *See generally* Note, *The Qualified Terminable Interest Rule: An Overview*, 34 U. FLA. L. REV. 737 (1982).

81. ERTA § 403(d)(3)(A)(1) (codified as amended at I.R.C. § 2044 (1982)); *see infra* notes 131-32 and accompanying text.

82. ERTA § 403(d)(4)(A) (codified as amended at I.R.C. § 2207A (1982)) *see infra* notes 133-35 and accompanying text.

83. *See* Note, *supra* note 80; *see also* Casner, *American Law Institute Federal Estate and Gift Tax Project*, 22 TAX L. REV. 545, 549-57 (1967).

84. Casner, *supra* note 83, at 549-53; Note, *supra* note 80, at 743-45.

indeterminate, less than the lifetime of the spouse.[85] The proposal also contained a provision that any additional tax liability which might be imposed on the transferee spouse could be satisfied only from the particular property subject to beneficial enjoyment by the spouse.[86]

The ALI proposal was not made part of the Tax Reform Act of 1976. However, it formed the basis for the qualified terminable interest property exception which was incorporated into the Code by ERTA.[87] The qualified terminable interest exception of Code section 2056(b)(7) accomplishes the same purpose as the beneficial enjoyment rule contained in the ALI proposal.[88] The Code, however, provides special treatment only for property in which the spouse has a life interest in contrast to the ALI proposal which would have provided special treatment for less than life interests.[89]

The qualified terminable interest rule is contained in three separate sections of the Code. The basic rule is found in section 2056(b)(7) and provides that property which meets certain requirements is eligible for the marital deduction from the estate of the decedent spouse.[90] Section 2044 provides that any property for which a deduction under the qualified terminable interest rule was previously taken will be included in the estate of the transferee spouse.[91] This section, however, does not apply if the transferee spouse has already made a lifetime disposition subject to tax liability under section 2519.[92] Finally, section 2207A provides that the transferee spouse shall have a right to recover any additional transfer tax imposed under section 2044 or section 2519 from the person or persons who receives the property.[93]

VI. Requirements for QTIP

Section 2056(b)(7) provides that the estate will be entitled to a marital deduction for qualifying property passing to the spouse for which an election is made.[94] The first thing to note is that the executor must elect to treat the property as qualifying property or the deduction will be lost.[95] This require-

85. *General Tax Reform: Panel Discussion Before the House Comm. on Ways and Means*, 93rd Cong., 1st Sess. at 10 (1973).

86. *Id.*

87. Note, *supra* note 80, at 745.

88. *Id.*

89. I.R.C. § 2056(b)(7) (1982). A qualified terminable interest includes only property in which "the surviving spouse has a qualifying income interest *for life*." *Id.* (emphasis added); *see infra* notes 101-07 and accompanying text.

90. I.R.C. § 2056(b)(7) (1982); *see infra* notes 94-114 and accompanying text.

91. I.R.C. § 2044 (1982); *see infra* notes 129-37 and accompanying text.

92. I.R.C. § 2044 (1982); *see infra* notes 138-56 and accompanying text for a discussion of section 2519.

93. I.R.C. § 2207A (1982); *see infra* notes 135-37, 146-49 and accompanying text.

94. I.R.C. § 2056(b)(7) (1982).

95. *Id.* The deduction is available for property "to which an election under this paragraph applies." *Id.* § 2056(b)(7)(B)(i)(III) (1982). The election "shall be made by

ment is unique to the QTIP exception to the nondeductible terminable interest rule.[96] The election should be made only after careful consideration of the immediate consequences to the estate and the subsequent consequences to the spouse.[97] Indeed, the mere fact that Congress provided the option should cause the prudent executor to hesitate before claiming the elective deduction.

The election, however, can only be made for qualifying property. Qualifying property is defined in the Code as property that passes from the decedent and in which the spouse has a qualifying income interest for life. To meet this test, three requirements must be met: 1) the surviving spouse must be entitled to all of the income from the property;[98] 2) the income must be payable annually or more frequently; and 3) no person may have a power to appoint any part of the property to any person other than to the surviving spouse.[99]

It is noteworthy that these are also three of the five requirements for the life estate general power of appointment exception to the nondeductible terminable interest rule. The two additional requirements for the life estate general power of appointment exception are that the surviving spouse must have a power to appoint the property to herself or her estate and that there can be no limitations on the exercise of that power, i.e., the power must be exercisable alone and in all events.[100] The lack of these two requirements is the distinguishing feature of new qualified terminable interest property. Because it is no longer necessary to give the surviving spouse a general power of appointment, which is equivalent to full ownership, it is possible for the decedent spouse to retain complete control over the ultimate disposition of the property and still qualify the property for the marital deduction.

The first requirement for a qualifying income interest for life is that the surviving spouse must be entitled to all the income from the property for her life.[101] Any interest for less than life will not qualify.[102] This requirement is

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the executor on the return of tax imposed by section 2001. Such an election, once made, shall be irrevocable." *Id.* § 2056(b)(7)(B)(v).

96. There is no election requirement for the other three exceptions to the terminable interest rule. *Id.* § 2056(b)(3), (5), (6).

97. *See infra* notes 119-54 and accompanying text.

98. The proposed regulation for § 2056(b)(7) explicitly adopts "the principles outlined in Treas. Reg. § 20.2056(b)-5(f) (governing life estates with a general power of appointment), relating to whether the spouse is entitled for life to all of the income from the entire interest." Prop. Reg. § 20.2056(b)-7(a), 1984-25 I.R.B. 15, 16-17.

99. I.R.C. § 2056(b)(7)(B)(ii) (1982).

100. The reader will recall that the five requirements for the life estate general power of appointment are: (1) the spouse must be entitled to all of the income from the property, all of the income from a specific portion of the property, or a specific portion of all the income; (2) the income must be payable annually or more frequently; (3) the spouse must have a general power of appointment exercisable in favor of the spouse or the spouse's estate; (4) the power must be exercisable alone and in all events; and (5) there must be no power in any other person to appoint away from the spouse. Treas. Reg. § 20.2056(b)-5 (1984); *see supra* notes 48-68 and accompanying text.

101. I.R.C. § 2056(B)(7)(b)(ii)(I) (1982). The regulations governing this requirement under the life estate general power of appointment were intended by Con-

similar to the initial requirement for a life estate general power of appointment, but it is not identical. The life estate general power of appointment exception requires that the surviving spouse receive all the income from the entire interest or a specific portion of the entire interest or a specific portion of all the income from the entire interest.[103] As we have seen, the term "specific portion of the income" has been held by the Supreme Court to include lump sum payments such as annuities.[104] Section 2056(b)(7)(B)(iv) provides that the term property shall be construed to include a specific portion of the property.[105] The Code is silent on the proper manner to treat a specific portion of the income. It does, however, provide that an annuity shall be treated as an income interest in property to the extent provided in the Regulations.[106] This provision was added by the Technical Corrections Act of 1982 and appears to conform the operation of this requirement for qualified terminable interest property to the similar requirement for the life estate general power of appointment although the two Code provisions take different routes to reach the same result.[107]

The second requirement for a qualifying income interest is that the surviving spouse must be entitled to the income annually or more frequently.[108] This requirement is identical to the second requirement for the life estate general power of appointment exception and presumably should be subject to the

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gress to apply to QTIP. The income interest will qualify for the deduction if it "provides the spouse with rights to income which are sufficient to satisfy the rules applicable to marital deduction trusts under present law." H.R. REP. No. 201, 97th Cong., 1st Sess. 161 (1981), *reprinted in* 1981-2 C.B. 352, 378; *see also* Treas. Reg. § 20.2056(b)-5(f) (1984); *supra* notes 48-50 and accompanying text.

102. *Cf.* Treas. Reg. § 20.2056(b)-5(f) (1984) (describing the income for life requirement under the life estate general power of appointment exception).

103. *See supra* notes 48-50 and accompanying text.

104. Northeastern Penn. Nat'l Bank & Trust v. United States, 389 U.S. 213 (1967); *see supra* note 50 and accompanying text.

105. I.R.C. § 2056(b)(7)(B)(iv) (1982). The statutory language provides that "[a] specific portion of property shall be treated as separate property." *Id.*

106. *Id.* § 2056(b)(7)(B). "To the extent provided in regulations, an annuity shall be treated in a manner similar to an income interest in property (regardless of whether the property from which the annuity is payable can be separately identified)." *Id.* The regulation requires that "any partial election shall relate to a fractional or percentile share of the property." Temp. Reg. § 22.2056-1(a) (1984).

107. Temp. Reg. § 22.2056-1 (1984) notwithstanding, there is no apparent basis for deciding that the *Northeastern* case would not apply. The Commissioner is apparently attempting to distinguish between a previously fixed lump sum payment and one which is determined only at the time the election is made. Thus, the Commissioner is taking the position that if the amount of periodic payments is fixed in the testamentary instrument, the deduction will be permitted. *See* Northeastern Penn. Nat'l Bank & Trust v. United States, 389 U.S. 213 (1967). However, if the amount of the periodic payments is to be fixed on the basis of an election under § 2056(b)(7), the Commissioner would disallow the deduction unless the amount is expressed in fractional terms. *See* Temp. Reg. § 22.2056-1(b) (1984). This position appears to be untenable under the *Northeastern* rationale.

108. I.R.C. § 2056(b)(7)(B)(ii)(I) (1982).

same regulations.[109] The important thing to remember is that the property must either be a residence or income producing, unless the surviving spouse has the right to compel conversion or exchange of the unproductive property for income producing property.[110]

The final requirement is that no one may have a power to appoint any portion of the property to any person other than the surviving spouse during the life of the spouse.[111] Thus, the Service has ruled that a trust which was to pay all income to the spouse quarterly, as well as to distribute corpus to the spouse as requested, which trust was coupled with a power in the trustee to invade the corpus for "any person" the surviving spouse was supporting, does not qualify for the deduction because there was a power to appoint for the benefit of someone other than the surviving spouse.[112] If the power to invade had been limited, however, to a power to invade for the support and maintenance of any person the spouse was legally obligated to support, the marital deduction would not have been disallowed.[113] This is true because a payment in satisfaction of the legal obligation of the surviving spouse is deemed the equivalent of a distribution to the spouse.[114]

VII. Making the Election

Once the requirements for a qualifying income interest for life are met, an election must be made to claim the marital deduction for the qualifying property or there will be no deduction.[115] The regulations provide that the election can be made for only a portion of the property. The portion, however, must be expressed in fractional or percentage terms of the qualifying property.[116] A published Letter Ruling has approved a fractional election using a formula clause geared to values finally determined for federal estate tax purposes.[117] If there is more than one trust or group of property for which the

109. *See* Note, *supra* note 80, at 747.

110. Treas. Reg. § 20.2056(b)-5 (1984); *see supra* notes 51-54 and accompanying text.

111. I.R.C. § 2056(b)(7)(B)(ii)(II) (1982). See *supra* notes 53-58 and accompanying text for a discussion of this requirement as applied to the life estate general power of appointment exception.

112. Letter Rul. 8319009, Feb. 4, 1983.

113. *Id.* The trust in question was subject to a power to invade for the "support, maintenance and education . . . of any . . . beneficiary or of any person being supported by such beneficiary." Thus, the power to invade was limited by an ascertainable standard. I.R.C. § 2041(b)(1) (1982). If the power had been further limited to the benefit of persons whom the surviving spouse was legally obligated to support, this trust would have been eligible for the QTIP election. This would be true because a payment in fulfillment of a legal obligation of the surviving spouse is deemed the equivalent of a payment to the surviving spouse.

114. Treas. Reg. § 20.2056(b)-5(j) (1984).

115. Temp. Reg. § 22.2056-1(b) (1984).

116. *Id.*

117. Letter Rul. 8301050, Sept. 30, 1982.

election is available, it must be made for each such trust or property or the marital deduction will be lost unless it is specifically elected. The election must clearly indicate for which property the election is being made if there is more than one possibility.[118]

The responsibility for making the election rests with the executor of the estate.[119] The primary duty of the executor is to protect the assets of the estate during the period of probate. Thus, from a purely fiduciary standpoint it would appear initially that the executor is obligated to make any election which would serve to reduce the tax liability of the estate. However, the rationale behind this position is largeiy obviated when we realize that while the actual duties of the executor do not extend beyond the period of probate, it is expected that the executor will exercise the necessary foresight to insure that the ultimate disposition of the estate assets conforms to the wishes of the testator. In some cases it may be necessary to take actions which appear detrimental in the short run to insure the ultimate fulfillment of the testamentary plan.

In a typical QTIP situation, a decision foregoing the election to treat an eligible life interest as qualified property is likely to result in a significant additional tax burden on the estate.[120] However, such a decision may, in certain circumstances, be necessary to safeguard the testamentary assets until the time of their ultimate disposition even if it places an additional tax burden on the initial testamentary transfer. For example, if the potential estate of the surviving spouse is significantly greater than the estate of the decedent spouse, it would not be prudent to make the election. In such a case, the asset, which would be included in the estate of the surviving spouse, would be taxed at the higher rate applicable to the estate of the surviving spouse at the time of the ultimate disposition. Assuming an asset valued at $100,000, a forty percent tax bracket for the estate of the decedent spouse, and a fifty percent tax bracket for the estate of the surviving spouse, an election to treat the asset as qualifying property would result in a net transfer tax loss of $10,000 on the ultimate disposition of the property.[121] If the asset is increasing in value, how-

118. *Id.* The Commissioner will not attempt to guess the intent of the executor.

119. *Id.* In the case of QTIP under the gift tax, the election is made by the donor spouse on his gift tax return. I.R.C. § 2523(f)(4) (1982); *see also* Letter Rul. 8335033, May 26, 1983 (allowing a trustee to make the QTIP election when all the decedent's assets passed by operation of law and there was no executor).

120. The Code provides that an election must be made to claim QTIP as a marital deduction. If no election is made, the value of the asset will be included in the decedent's taxable estate. I.R.C. § 2056(b)(7) (1982). Accordingly, the estate tax burden will be increased because of the increased value of the estate. *Id.* at § 2001(b)(1)(A). The present discussion ignores the benefit derived from tax deferral alone. With the present high interest rates, this benefit is likely to be substantial. A discussion of this benefit however, is beyond the scope of this article.

121. This is true because, based on an assumed 40% tax bracket for the decedent's estate, the amount of tax imposed would be $40,000. If, however, the estate is taxed at a 50% rate, the amount of tax imposed would be $50,000. The surviving spouse's estate may then exercise a right to recover this additional $10,000 tax burden from the ultimate beneficiaries of the asset. *Id.* § 2207A; *see infra* notes 135-37 and

ever, some, or all, of this increased transfer tax liability may be offset by a decrease in income tax because of a step-up in the basis of the property at the time of the transfer to the surviving spouse.[122]

Likewise, the QTIP election should not be made when the unified credit of the decedent spouse has not been exhausted.[123] This will be true even in cases where it appears that the potential estate of the surviving spouse will be smaller than that of the decedent spouse and will be completely covered by the unified credit available to the surviving spouse. There is no guarantee that the unified credit of the surviving spouse will not be exhausted by subsequent lifetime transfers or by an increase in the potential value of the estate of the surviving spouse.[124] The available unified credit of the decedent spouse, however, is a known quantity at the time of probate.[125] Additionally, any credit which is not exhausted by the decedent's estate will be lost forever.[126] The prudent executor should carefully guard against such a result.

Additionally, there is a real possibility that the beneficiaries of the various QTIP-able interests will have conflicts regarding the election for various interests. In other words, the benefits in tax savings to one party may be at the expense of another party. If there will be no ultimate tax advantage unless the election is made for only a portion of the assets, the potential conflict could create problems. Since a portion of the assets would then be subject to taxation as part of the decedent's estate while another portion is subject to inclusion in the estate of the surviving spouse, the tax rate is likely to be different for similarly situated assets.[127] If the decision on which assets to treat as QTIP is made arbitrarily, the termination of the estate may well be held up by a challenge from the ultimate beneficiary of the asset which has been subjected

accompanying text. Thus, if included in the decedent's estate, the ultimate beneficiaries would be entitled to receive $60,000 ($100,000 - $40,000); if, however, an election is made under § 2056(b)(7), the ultimate beneficiaries will receive only $50,000 ($100,000 - $50,000), a net loss of $10,000.

122. *See* I.R.C. § 643(a)(2) (1982) (excluding gains from the sale or exchange of capital assets from distributable net income to the extent they are allocated to corpus and not paid, credited, or distributed to any beneficiary during the taxable year); *id.* § 1014 (stating that the basis of property received by testamentary disposition is its fair market value at the time of the decedent's death). For an analysis of why QTIP should be treated as "passing" to the surviving spouse, see Note, note 80 *supra*, at 762; I.R.C. § 2044(c).

123. The unified credit against estate and gift tax may be found in I.R.C. § 2010 (1982) (estate) and I.R.C. § 2505 (1982) (gift). The current (1984) value of the unified credit is $96,300. Unless this provision is amended the amount of the credit will stabilize at $192,800 in 1987. I.R.C. §§ 2010, 2505 (1982).

124. *Id.* § 2505. The general rule is that the statutory amount of the unified credit is to be reduced by "the sum of the amounts allowable as a credit to the individual under this section for all preceding calendar periods." *Id.* § 2505(a) (1982).

125. This is true because there will be no further deductions based on the amount of credit used in calendar periods which precede the decedent's death. *Id.*

126. The unified credit is a personal right of the decedent and is not transferrable. *Id.* § 2010.

127. *See supra* note 120 and accompanying text.

to the higher tax rate.[128] This could result in expensive litigation which may severely diminish the value of the estate and should be studiously avoided by the prudent executor. To prevent the executor from being criticized by the persons adversely affected by making or not making the QTIP election, an appropriate clause should be inserted in the instrument.

VIII. Effect of Making the Election on the Surviving Spouse

The effect on the surviving spouse of making a section 2056(b)(7) election is governed by three sections of the Code. Section 2044 provides that any asset for which an election was made under section 2056(b)(7) and which was not the subject of a lifetime disposition by the surviving spouse will be included as a part of the gross estate of the surviving spouse at death.[129] Section 2519 governs the tax imposed on the surviving spouse donor for a lifetime transfer of any such property made for less than adequate and full consideration.[130] The proposed regulation to section 2519 presumes that the election was made if available and places the burden on the surviving spouse to prove that it was not taken.[131] Section 2207A attempts to soften the blow of the additional tax liability imposed on the surviving spouse by imposing a right of recovery for any additional tax imposed as a result of either section 2044 or section 2519.[132]

The effect of section 2044 is relatively straightforward. If the election was made previously the asset will be included in the estate unless a lifetime disposition has been made by the surviving spouse.[133] The only way to avoid inclusion is through a lifetime disposition of the property, which is likely to be unwise for various reasons.[134] The surviving spouse's estate is entitled to recover any additional tax imposed on the estate as a result of inclusion from the ultimate beneficiary of the QTIP asset.[135] The amount of recovery is deter-

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128. *See* Strauss, *Qualified Terminable Interest Property Offers New Opportunities But Many Problems Are Unresolved*, 9 Est. Plan. 74, 79-80 (1982).

129. I.R.C. § 2044 (1982); *see infra* notes 133-34 and accompanying text.

130. I.R.C. § 2519 (1982); *see infra* notes 138-45 and accompanying text.

131. Prop. Reg. § 25.2519-1(b) (1984).

132. I.R.C. § 2207A (1982); *see infra* notes 135-36, 146-49 and accompanying text.

133. I.R.C. § 2044 (1982). The statute provides that:

> [t]he value of the gross estate shall include the value of any property to which this section applies in which the decedent had a qualifying income interest for life . . . . This section applies to any property if (1) a deduction was allowed . . . (A) under section 2056 by reason of subsection (b)(7) thereof, or (B) under section 2523 by reason of subsection (f) thereof, and (2) section 2519 . . . did not apply with respect to a disposition by the decedent of part or all of such property.

Id.

134. *Id.* § 2044(b)(2) (1982). See *infra* notes 150-56 for a discussion of the potentially disastrous tax consequences of a lifetime disposition.

135. *Id.* § 2207A. The text of the act provides:

mined by calculating the difference between the tax imposed and the amount of tax which would have been imposed if the asset had not been included in the estate.[136] The section 2207A right of recovery may be waived by the surviving spouse through her testamentary instrument.[137]

The effect of section 2519 is considerably more complicated. That section provides for a transfer tax imposed on the surviving spouse whenever there is a lifetime transfer of any portion of an interest for which an election was made under section 2056(b)(7).[138] The only portion of QTIP which is capable of lifetime disposition by the surviving spouse is the income interest, because the characteristic feature of QTIP is that the ultimate disposition of the property is dictated by the decedent spouse.[139]

The difficulty in applying section 2519 lies in determining what portion of the interest is deemed transferred and thus subject to taxation. There are two distinct interests in every qualifying trust, the income interest and the remainder.[140] As originally enacted, section 2519 provided that "[a]ny disposition of all or part of a qualifying income interest for life in any property to which this section applies shall be treated as a transfer of such property."[141] From this language it was unclear whether section 2519 applied only to that portion of the income transferred, the entire income interest, the pro rata portion of the remainder to which the income could be attributed, the entire remainder, or the entire income interest and the entire remainder. The Technical Corrections Act of 1982 clarified this by amending section 2519 to read "[a]ny disposition of all or part of a qualifying income interest for life in any property to which

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> If any part of the gross estate consists of property the value of which is includable in the gross estate by reason of section 2044 . . . the decedent's estate shall be entitled to recover from the person receiving the property the amount by which (A) the total tax under this chapter which has been paid, exceeds (B) the total tax under this chapter which would have been payable if the value of such property had not been included in the gross estate.

Id.

136. *Id.*

137. *Id.* § 2207A(a)(2). The right of recovery "shall not apply if the decedent otherwise directs by will." *Id. See generally* Strauss, *supra* note 128.

138. I.R.C. § 2519 (1982). The text provides in pertinent part that:

> any disposition of all or part of a qualifying income interest for life in any property to which this section applies shall be treated as a transfer of all interests in such property other than the qualifying income interest.
> (b) . . . This section applies to any property if a deduction was allowed with respect to the transfer of such property to donor (1) under section 2056 by reason of subsection (b)(7) thereof, or (2) under section 2523 by reason of subsection (f) thereof.

Id.

139. *Id.* § 2056(b)(7). Recall that the purpose was to avoid forcing the decedent "to choose between surrendering control of the entire estate at his death or reducing his tax benefits at his death to insure inheritance to his children." H.R. REP. NO. 201, 97th Cong., 1st Sess., *reprinted in* 1981-2 C.B. 352.

140. I.R.C. § 2056(b)(7) (1982).

141. ERTA § 403(d)(3)(B)(i).

this section applies shall be treated as a transfer of *all interests* in such property *other than the qualifying income interest.*"[142]

Thus, the Technical Corrections Act makes it clear that *any* transfer of a qualifying income interest will be treated as an imputed transfer of the entire remainder corpus.[143] The proposed regulations appear to provide relief only if the original election was made for only a portion of the interest.[144] This can lead to disastrous tax consequences by subjecting the entire value of the corpus to taxation at the time of even a minor disposition.[145] It is unclear how the section 2207A right to recover increased tax is affected by this imputed transfer. There are three possibilities: 1) the section 2207A right to recovery may be exercised against the recipient of the interest actually transferred; 2) the right of recovery may be exercised against the ultimate recipient of the remainder interest; or 3) the right of recovery is forfeited to the extent of the unused unified credit of the transferor.[146] The proper answer appears to be that the right of recovery is forfeited to the extent of any remaining unified credit of the surviving spouse transferor and that any excess tax is then the subject of a section 2207A right of recovery against the beneficiary of the imputed transfer of the remainder.[147] This is so because the section 2207A right of recovery applies only to the extent that the tax liability of the surviving spouse is increased by the disposition.[148] Since there will be no actual tax liability to the transferor to the extent that there is remaining unified credit available, and the unified credit must be claimed, the section 2207A right of recovery will be forfeited along with the unified credit.[149]

It is easy to foresee several disastrous tax consequences as a result of such

142. Technical Corrections Act of 1982, Pub. L. No. 97-448, 96 Stat. 2381 (1982); § 104(a)(3)(A) (codified as amended at I.R.C. § 2519(a) (1982)) (emphasis added).

143. *Id.* See Note, *supra* note 80, at 753-54 for a discussion of the confusion possible under the sections originally enacted.

144. Prop. Reg. § 25.2519-1 (1984).

145. The code language is very clear that "*any disposition* of all *or part* of a qualifying income interest . . . shall be treated as a transfer of *all interests* . . . *other than the qualifying income interest.*" I.R.C. § 2519(a) (1982) (emphasis added).

146. The statutory language that the donor shall be entitled to recover "from the person receiving the property" offers no guidance. *Id.* § 2207A(b). Remember, however, that the recipient of the imputed transfer is the ultimate beneficiary, and is the "person who receives the property" within the statutory meaning. Thus, the right of recovery should be exercisable against the beneficiary of the imputed transfer of the remainder.

As to the effect on the unused unified credit, the Code provides for a right of recovery only to the extent that the tax for the year exceeds "the total tax which would have been *payable* . . . for such year if the value of such property had not been taken into account." *Id.* (emphasis added). Inclusion of the word "payable" indicates that available credits should be taken into account. Thus, the right of recovery seems to be forfeited to the extent that the donor possesses remaining unified credit.

147. *Id.*

148. *Id.*

149. *Id.*

a lifetime transfer. In addition to the consequences outlined above, it is likely that the imputed transfer of the remainder interest under section 2519 will not be reported because it is not apparent to the transferor when filing a return. This could very quickly lead to numerous and costly tax penalties, especially if the value of the remainder is large.[150] The surviving spouse may also be subject to capital gains income tax on the qualifying property at the time of disposition.[151] However, the surviving spouse is entitled to a step-up in basis of the QTIP property to the time of the transfer to the surviving spouse.[152] There is no right of recovery for capital gains income tax.[153]

In addition to triggering the imputed transfer of the remainder interest, the transfer of the income interest is an actual transfer by the spouse which is subject to taxation according to the rules generally applicable to life interests.[154] This is true because the surviving spouse is the "actual" owner of the income interest in addition to being the "imputed" owner of the remainder interest.[155] Therefore, a transfer of the "actual" income interest should be treated in the same manner as a transfer of any other interest.[156]

IX. Use of the QTIP in Estate Planning

As we have seen, one of the major objectives of estate planning is to minimize the aggregate tax liability of the couple. Of course, consideration must be given to the benefit of deferral of the estate tax until the death of the surviving spouse.[157] This is generally accomplished by equalizing the value of the adjusted gross estate for each spouse to minimize the aggregate tax liability of the couple.[158] The QTIP exception can be used to accomplish this purpose in much the same way as the life estate general power of appointment.[159] How-

150. For the potential cost to the taxpayer, see *id.* at § 6651 (governing the penalties for failure to file a return or pay the tax); *id.* § 6653 (penalty for negligent or intentional failure to pay tax); *see also id.* § 2505.

151. *Id.* § 61; § 1202 *et seq.*

152. *See id.* § 1014(a) (governing basis of property received through testamentary disposition); *supra* note 122.

153. I.R.C. § 2207A (1982). The right of recovery applies only to tax imposed under the estate and gift tax chapters. *Id.*

154. The Committee Report states that:

> The bill clarifies that the special rule, providing for a constructive gift as a result of a lifetime transfer by the donee spouse of an income interest in QTIP property, applies only to the remainder interest in QTIP property. The tax treatment of the life estate in QTIP property is governed by the rules generally applicable to any life estate held by the surviving spouse.

Sen. Rep. No. 592, 97th Cong., 2nd Sess. 21 (1982), *reprinted in* 1983-1 C.B. 475, 483.

155. *See* Note, *supra* note 80, at 752-54.

156. *Id.*

157. *See supra* notes 69-77 and accompanying text.

158. *Id.*

159. For a discussion of the use of the life estate general power of appointment in estate planning, see *supra* notes 69-77 and accompanying text.

ever, the QTIP permits added flexibility for post-mortem planning, because the election to claim the marital deduction for a certain portion of the property is made after the death of the first spouse.[160]

We should always be mindful, however, that there is a difference between good tax planning and good estate planning. In tax planning, the overriding objective is to save taxes even if the client's needs are not met. For example, if the client's potential estate includes substantial non-liquid assets, such that the estate taxes could be paid only by selling the assets at a heavy loss, the estate tax marital deduction could be a very valuable deduction. Prior to QTIP, the only way to insure the marital deduction for the decedent's estate would be to give the surviving spouse outright ownership, or its equivalent.[161] This is excellent tax planning.

But now suppose that, for whatever reason, the client despises his spouse. Under these circumstances, it would still be excellent *tax* planning to give the surviving spouse outright ownership, or its equivalent, of the non-liquid assets. Now, however, this *excellent tax planning would be very poor estate planning* because it would ignore the client's wishes. Fortunately for our client, this forced choice is no longer necessary because of QTIP.

Thus, the most common use of the QTIP is likely to be that envisioned by Congress; to permit the donor/decedent spouse to control the ultimate disposition of the property without forfeiting the marital deduction.[162] This is likely to be particularly attractive to persons who have remarried and, although they wish to provide for their spouse during life, also wish to insure that their property, or a portion thereof, ultimately passes to others of their choosing. Prior to QTIP it was necessary to forfeit the marital deduction to accomplish this result.[163] The only alternative was to give the surviving spouse a life estate with a general power of appointment which could be exercised to defeat the wishes of the decedent spouse.[164]

X. SAMPLE QTIP

Suppose, for example, that husband (*H*) has two children from a previous marriage. His current wife (*W*) also has two children from her previous marriage. There are two additional children from the present marriage, for a total of six children.

Now, also suppose that *H*, in making his will, wishes to dispose of three different types of property: 1) $100,000 of income producing general stock; 2) the home which he shares with his current wife (valued at $100,000); and

160. I.R.C. § 2056(b)(7) (1982). The executor must make the election on the estate tax return. Temp. Reg. § 22.2056-1(a) (1984).

161. *See supra* notes 7-10 and accompanying text.

162. *See* H.R. REP. No. 201, 97th Cong., 1st Sess., *reprinted in* 1981-2 C.B. 352.

163. *Id.*

164. I.R.C. § 2056(b)(5) (1982).

3) a pleasure yacht.[165] *H* wishes to leave each of these items to *W* for life, then to the children from his first marriage.

W is the executor of *H*'s estate. As executor, she determines that the proper marital deduction to minimize the aggregate tax liability between the estate of *H* and the potential estate of *W* would be approximately $150,000.[166] How should she make the section 2056(b)(7) election to accomplish this result?

First, she should disregard the pleasure yacht as a potential marital deduction because it is neither income producing nor a residence.[167] She should then elect to claim the full value of the home as a marital deduction under section 2056(b)(7). The house qualifies even though it is not an income producing asset because it is the family residence. Finally, she should elect to claim fifty percent of the income producing stock as a marital deduction. This is possible because the regulations provide that partial elections are permissible.[168] It is wise to make the partial election for the stock, because it would be difficult to apportion the house in a satisfactory manner.

Now, suppose that five years later the value of the home has increased to $150,000. *W* decides that she wishes to travel and rents the home to a young couple (unrelated to *W*) for one year at a fair market rate. What are the gift tax consequences? There is no gift tax due for the actual interest transferred, i.e., the right to live in the home for one year, because that transfer was made for full and adequate consideration.[169] However, there is an imputed transfer of the full value of the residence, now $150,000, to the remaindermen which is subject to taxation under section 2519.[170] *W*'s unified credit is reduced by an amount equal to the tax on $150,000.[171] There is no right of recovery unless the unified credit is exhausted and an actual payment is required.[172]

Five years later, *W* dies. The stock for which the election was not made is not includable in her estate because she had a mere life interest.[173] The value

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165. These are not meant to be the sole assets of the estate. They are, however, the only assets for which QTIP treatment will be sought and therefore are the only assets relative to this hypothetical example. It is assumed that there are other assets sufficient to subject the estate, as a whole, to estate tax liability.

166. This is merely an assumed value for the purposes of this example. See *supra* notes 69-77 for a discussion of the tax advantages of this type of estate plan using a life estate general power of appointment.

167. I.R.C. § 2056(b)(7) (1982); Treas. Reg. § 20.2056(b)-5(f) (1984); *see supra* note 54.

168. Temp. Reg. § 22.2056-1(b) (1984); *see supra* notes 103-07 and accompanying text.

169. If the transfer was made for adequate and full consideration in money or money's worth, there is no gift. *See* I.R.C. § 2512(b) (1982); Treas. Reg. § 25.2512-8 (1984).

170. I.R.C. § 2519 (1982); *see supra* notes 140-49 and accompanying text.

171. I.R.C. § 2519 (1982); *see supra* notes 146-49 and accompanying text.

172. I.R.C. § 2207A (1982); *see supra* notes 146-49 and accompanying text.

173. I.R.C. § 2044 (1982); *see supra* notes 133-34 and accompanying text.

of the house, and of the stock for which the election was made, is not includable in *W*'s estate because it has already been subjected to taxation pursuant to section 2519.[174]

XI. Use of QTIP in Planning

Use of the QTIP is most likely to appeal to the testator who has been previously married and wishes to provide for the children from his first marriage. Prior to QTIP, this testator was forced to make a serious choice. To gain the marital deduction for his estate, he had to be willing to potentially disinherit everyone except his wife, including the children from his first marriage. This was a difficult and unfair choice. Therefore, Congress created QTIP so that the testator would not be forced to make this decision. What QTIP does is permit this testator to ensure that his children from his first marriage, the natural objects of his bounty, will receive his property, *and* to take advantage of the estate tax marital deduction. Thus, this testator is no longer forced to abandon the significant tax benefits of the marital deduction in order to achieve his non-tax objective.

The tax disadvantage of QTIP is that the entire asset will be included in the estate of the surviving spouse and valued at the time of her death. Fortunately, her estate, i.e., the executor, will be able to recover the additional tax from the remaindermen. Additionally, QTIP places the executor in a very difficult position. The executor will be forced to evaluate the situation at the time of death of the original testator. In order to make the proper decision, the executor must not only be fully aware of all the present facts and circumstances, but must also be able to look into a crystal ball to predict future events.

Indeed, it is just such a future event, the lifetime disposition of property for which the election was made, which can take a seemingly wise election under section 2056(b)(7) and turn it into a disaster. As we have seen, section 2519 and the Committee Reports provide that a disposition of any part of an interest for which an election was made triggers an imputed transfer of the entire interest. Thus, under the statute, a five dollar gift could trigger an imputed transfer of several million dollars which would be taxable at the time of the five dollar transfer. Under certain circumstances, if the asset is increasing in value, this could be excellent planning.

The imputed transfer rule, however, seemingly defies logic. To most laymen, and to perhaps many lawyers, this result seems absurd. Therefore the imputed transfer is likely to go unreported. In all likelihood it will not be discovered until after the death of the surviving spouse. This could be several years after the imputed transfer. In the meantime the surviving spouse will be accumulating substantial penalties for failing to pay tax on the imputed transfer. Fortunately for the surviving spouse, the right of recovery includes penal-

174. I.R.C. § 2044 (1982).

ties.[175] The value of the asset, however, is likely to be largely consumed.

This is a terribly harsh result. Under the present law, the surviving spouse would have to be warned of this possibility. Remember, we are most likely dealing with an older person who is not a tax expert and to whom this seems like an absurd possibility. Thus, executors and trustees may virtually have to live with the surviving spouse. Their potential liability for malpractice would increase greatly. It may be necessary to insert special provisions giving executors and trustees great discretion to protect against the increased liability. These provisions may not be enforced by the courts.

To remedy this potentially disastrous scenario, the Service should promulgate regulations, retroactively effective to the effective date of ERTA, providing that a gift of income should be limited to the value of the income right. A lump sum gift of income should be limited to the value of the lump sum. Further, Congress should amend section 2519 to permit the Service to ameliorate the effect of the current language that a transfer of any interest in the property is a transfer of the entire interest. The Service could then issue regulations providing for a more appropriate proportional value of the transfer. Until this happens, however, the QTIP election must be made with extreme caution.

XII. Conclusion

We have seen that the QTIP exception is an extremely useful tool to enable a decedent to provide lifetime support for a surviving spouse and still retain control of the ultimate disposition of the property. QTIP has also been shown to be an extremely flexible tool for both pre- and post-mortem estate planning as a device for minimization of the aggregate tax liability of the couple. However, we have also seen that there are potential traps for the unwary, particularly in the area of imputed lifetime transfers under section 2519 and in the potential conflicts between beneficiaries with conflicting interests.

The QTIP provisions are extremely attractive to potential taxpayers. Some practitioners claim that ninety-five percent of their clients who are made aware of the QTIP deduction insist upon using it.[176] However, because of the many hidden problems which may arise, the QTIP should be used only with great care.[177]

175. Prop. Reg. § 20.2207A-1 (1984).

176. Strauss, *supra* note 128, at 74.

177. This article contains material utilized in Saving Time and Taxes in Planning and Preparing Estate, Trust and Fiduciary Tax Returns, by George Schain, 1985, Garland Publishing, Inc.