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The Lifetime QTIP Trust – the Perfect (Best) Approach to Using Your Spouse's New Applicable Exclusion Amount and GST Exemption

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INTRODUCTION

As part of the 2017 Tax Cuts and Jobs Act (Pub. L. No. 115-97, hereinafter the 2017 tax act), each individual's estate and gift tax exemption, otherwise known as the "basic exclusion amount" or BEA,[1] as well as the exemption from the generation-skipping transfer (GST) tax (such exemption is referred to as the "GST Exemption"),[2] was doubled. Based on the required annual inflationary adjustment calculations, in 2019, each individual has a BEA of $11.4 million and a GST Exemption of $11.4 million (collectively, the BEA and the GST Exemption may be referred to as the "Exclusions").[3] The Exclusions will continue to be increased annually for inflationary purposes until 2026, when they return to the 2011 threshold of $5 million with annual inflationary adjustments (which, in 2026, is estimated to be approximately $6 million[4] for a single person or $12 million for a married couple).

Prior to the 2017 tax act, it was estimated that 99.8% of the U.S. population would not be required to file a U.S. Estate (and Generation-Skipping Transfer) Tax Return, Form 706 (a "706"), and, with the doubling of the Exclusions, this threshold is likely increased to 99.9%. These statistics quantify that, of the entire U.S. population, only 0.1% of the population has a gross estate for federal estate tax purposes (the "Gross Estate") in excess of $11.4 million (which is the current filing threshold for a 706).[5] Let that sink in for a moment – only one out of every 1,000 individuals will be required to file a 706. The conclusion from this analysis is that, with the passage of the 2017

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[1] §2010(c)(5). All section references are to the Internal Revenue Code of 1986, as amended (the Code), and the regulations thereunder, unless otherwise specified.

[2] §2631(b).

[3] The BEA is one component of the "applicable exclusion amount," or AEA. Each individual's AEA may be higher if the individual has received any deceased spousal exclusion amount from his or her most recently predeceased spouse. Throughout this article, references may be to either the BEA or the AEA.

[4] The $6 million amount is roughly calculated by determining what the exclusion would have been in 2026 (using the cost of living factor in effect prior to 2018) if the 2017 tax act had not been enacted.

[5] *See generally*, Center of Budget and Policy Priorities, *Policy Basics: The Federal Estate Tax* (Nov. 7, 2018). According to the Tax Policy Center, Urban Institute and Brookings Institution, it is estimated that out of the projected 2.7 million deaths in 2018, only 1,700 decedent's estates will pay an estate tax, which translates to 99.937% of estates passing transfer tax-free.

tax a ct, a major focus of estate planners is how to plan for the usage of the additional Exclusions for the 0.1% and others that could benefit from it prior to any roll back.

For many wealthy married couples, the assets are concentrated in one spouse (referred to as the ''More Affluent Spouse''). The less wealthy spouse (the ''Less Wealthy Spouse'') usually owns little or no assets, which presents the distinct possibility that he or she will waste his or her Exclusions. This was one problem that portability was intended to resolve; if the Less Wealthy Spouse died first, his or her unused AEA amount could pass to the More Wealthy Spouse.[6] However, portability only applies to the AEA; currently, there is no portability for the GST tax.

How, then, can the More Wealthy Spouse not only utilize the Less Wealthy Spouse's AEA, but also his or her GST Exemption? Considering both the current transfer tax landscape and our personal history of advocating the use of a lifetime qualified terminable interest property (QTIP) trust (referred to as a ''Lifetime QTIP Trust'') in the estate plans of wealthy married couples,[7] this article proposes that the solution to this quandary is the use of the Lifetime QTIP Trust.[8]

The Lifetime QTIP Trust creates five distinct planning advantages for the More Affluent Spouse: (1) the More Affluent Spouse can better (or, depending on the size of the estates, fully) utilize the Less Affluent Spouse's Exclusions, (2) the More Affluent Spouse can pass more property free of transfer taxes to his/her lower generations, (3) even more property can pass free of transfer taxes to the lower generations through the income tax advantages of grantor trust status, (4) enhanced creditor protection is available to both spouses, and (5) most importantly, the More Affluent Spouse can retain virtual control over the assets without adverse transfer tax or creditor consequences.

As can be inferred through the description of the technique, this approach has significant appeal to wealth holders in second (or third or fourth) marriages and especially where there is a significant gap in wealth between the More Affluent Spouse and the Less Affluent Spouse.

HISTORY AND UNDERSTANDING OF THE ISSUES

Often, to enjoy the use of a product or to appreciate a work of art, one does not need to be an engineer or art expert. For example, a baseball fan does not have to know the physics behind the movement of a ''cut'' fastball to know that Mariano Rivera threw the pitch with extreme dominance. Likewise, one does not have to understand the carving and sculpting techniques used by Michelangelo to appreciate his ''David.'' With tax or estate planning strategies, however, historical and background knowledge is extremely important for a comprehensive understanding of the particular strategy; otherwise, the planner may advise a client to engage in a transaction without appreciating the ramifications if the transaction is undone or is not properly implemented. With that premise, some background is useful before delving into the mechanics of the proposed Lifetime QTIP Trust strategy.

Current Exclusion Levels and Transfer Tax Rates

With respect to the actual imposition of transfer taxes, wealth in excess of the Exclusions is subject to transfer taxes at a federal rate of 40% (transfers subject to the GST tax are typically assessed at the time of a transfer subject to either estate or gift tax, or perhaps later in time in the case of a taxable distribution or termination).

As stated above, the amount of the federal Exclusions is $11.4 million for 2019, which is a $5.91 million increase from the 2017 amounts.[9] However, in 2026 (or perhaps earlier if control of the government changes to the Democrats),[10] the two Exclusions are scheduled to roll back to the pre-2018 levels. In the

[6] Under §2010(c)(4), the other component of the AEA, the ''deceased spousal unused exclusion amount,'' is the lesser of the BEA or the excess of the AEA of the last such deceased spouse of such surviving spouse over the amount with respect to which the tentative tax is determined under §2001(b)(1) on the estate of such deceased spouse. ''AEA'' is used above for simplicity purposes.

[7] *See* Richard S. Franklin & George D. Karibjanian, *An Oxymoron? The Deathbed Lifetime QTIP for Basis Adjustment and Asset Protection*, 41 Tax Mgmt. Est., Gifts & Tr. J, No. 6, p. 219 (Nov./Dec. 2016) (cited herein as ''Deathbed Lifetime QTIP''); Richard S. Franklin, *Creatively Using Lifetime and Testamentary QTIPs — A Federal and Washington Perspective*, 59th Annual Estate Planning Conference, Washington State Bar Assoc., Chapter Ten-A (October 2014); Barry A. Nelson & Richard S. Franklin, *Inter Vivos QTIP Trusts Could Have Unanticipated Income Tax Results to Donor Post-Divorce*, LISI Est. Pl. Newsletter #2244 (Sept. 15, 2014).

[8] For an in-depth analysis of Lifetime QTIP Trusts, *see* Richard S. Franklin, *Lifetime QTIPs: Why They Should be Ubiquitous in Estate Planning*, 50th Heckerling Inst. on Est. Plan. (Jan. 14, 2016) (published version: 50th U. Miami Heckerling Inst. Est. Plan. ¶ 16 (2016, U. Miami)). Hereinafter references to this article will be to ''Ubiquitous'' and use the published version's section references.

[9] Rev. Proc. 2018-18, §3.35. *See also*, §1602 of the 2017 tax act, which doubled the BEA from $5 million to $10 million, subject to sunset in 2026.

[10] *See e.g.*, Fred Hiatt, *It's open season on the wealthy. But not every tycoon should be flattened*, Wash. Post (Feb. 3, 2019); Aaron Blake, *Republicans call Ocasio-Cortez's and Warren's tax-the-wealthy plans 'radical.' Trump's were even more radical*, Wash. Post (Feb. 4, 2019); Jeff Stein, *'A very big experiment:' How Elizabeth Warren would try forcing billionaires to pay her wealth tax*, Wash. Post (Feb. 4, 2019); Helaine Olen, *How Donald Trump is helping Democrats to call for tax increases*, Wash. Post (Feb. 4, 2019); Steven Pearlstein, *Wealth tax. 70 percent rates. Medicare-for-all. Let's take a breath.*, Wash. Post (Feb. 5, 2019); Christopher Ingraham, *Over 60 percent of voters – including half of Republicans – support Elizabeth Warren's wealth tax*, Wash. Post (Feb. 5, 2019); Christopher Ingraham, *People like the estate tax a whole lot more when they learn how wealth is distributed*, Wash.

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2017 tax act, Congress did not drastically alter the transfer tax system by enacting a series of new statutes. Instead, all it did was increase the amount of the Exclusions; otherwise, the 2017 tax act left the entire transfer tax system in place.[11] Simply adjusting the Exclusion levels made Congress's work less involved. Recalling that the Democrats opposed the 2017 tax act, should control of both houses of Congress and the White House shift to the Democrats before 2026, it will be very easy for the Democrats to lower the Exclusion amounts by one of two methods – they could doing nothing all, thereby allowing the 2026 sunset to occur, or, if, at any time, they have the requisite Congressional majorities, they can then simply repeal the increased Exclusion amounts.[12]

The imposition of estate taxes is not limited to the federal government. At the state level, 12 and the District of Columbia[13] impose their own separate estate taxes at varying rates with varying exemptions. For example, the Maryland estate tax is imposed at a flat 16% for estate property in excess of its $5 million exemption.[14] Although a deduction is allowed at the federal level for the payment of state estate taxes,[15] this will still result in a higher overall estate tax rate. Consider the following example of a decedent, D, dying as a resident of State X with a gross estate of $21.4 million. D did not use any of his AEA during his lifetime. State X imposes a flat 12% tax rate on assets in excess of its $5 million exemption. Assuming that all of D's assets are subject to the State X estate tax, the State X estate tax is $1.968 million. For this purpose, the only deduction from the Gross Estate is the state estate tax (which is deductible under §2058). After applying D's AEA of $11.4 million, D's federal estate tax is $3,212,800. Combining the two estate taxes and dividing that by the amount of D's gross estate, D's overall effective combined estate tax rate is 24.21%. If D lived in a state that did not impose a separate estate tax, D's overall effective estate tax rate is only 15.01%. For the portion of the Gross Estate in excess of both the state exemption and the AEA, such property is taxed at a marginal combined estate tax rate of 47.2%.

Seeing the Sunset . . . Again

A long, long time ago — 2001 to be exact — Congress scheduled the repeal of the estate tax provisions for 2010. While the Republican-controlled House of Representatives wanted to completely repeal the estate tax, they were unable to do so as a result of the Senate's "Byrd Rule," and, as a result, the repeal "sunsetted" after 2010.[16]

What is the "Byrd Rule"? The Byrd Rule was adopted in 1985 and named for then Sen. Robert Byrd (D-W.V.), and generally applies to certain reconciliation bills that affect the budget. If a reconciliation bill contains an extraneous matter (such as one that would increase the federal deficit), a three-fifths majority (which, in a full Senate, is 60 votes), as opposed to a simple majority vote, is required to pass the bill as drafted; if the vote is at least a majority but less than the required three-fifth of votes, the legislation is considered to be passed by the Senate, but must terminate in less than 10 years (i.e., it "sunsets"), upon which the law as it existed before the new legislation's passage would once again be the applicable law.[17] As the Republicans were unable to obtain 60 votes for the

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Post (Feb. 6, 2019); Damian Paletta, and Jeff Stein, *Billionaires strike back as Democrats embrace higher taxes, economic populism*, Wash. Post (Feb. 6, 2019).

[11] For example, although it was the subject of great debate during the 2016 election season, the so-called "step-up in basis" rule upon death under §1014 is unchanged. This rule requires the cost basis of a decedent's assets to be adjusted to fair market value on the decedent's date of death. Generally, this rule is taxpayer favorable as it eliminates the potential capital gain that existed prior to death.

[12] While it may seem like a considerable amount of time has passed since Nov. 8, 2016, recall that Secretary Clinton, who most political pundits presumed would win the Presidency on Election Day, proposed to **decrease** the gift, estate, and GST tax exclusions to $3.5 million per person and raise the gift, estate, and GST tax rates to 45% (with an increased top rate for some ultra-high net worth estates to 65%). *See generally*, Robert W. Wood, *Hillary Clinton Vows 65% Estate Tax to Donald Trump's Repeal*, Forbes (Sept. 23, 2016).

[13] The following states impose a separate estate tax (exclusion amount for 2019 stated in parenthesis): Connecticut ($3.6 million, increasing to the federal BEA in 2020 (*see* Conn. Gen. Stat. §12-391(g)(5))); District of Columbia ($5,681,760; *see* D.C. Code §47-3702); Hawaii ($5.49 million; *see* Haw. Rev. Stat. §236E-6 and Hawaii Dept. of Tax. Ann. 2018-13)); Illinois ($4 million; *see* 35 Ill. Comp. Stat. §402/2); Maine ($5.7 million (exemption is set at $5.6 million and is adjusted for inflation for decedent's dying after January 1, 2018); *see* Me. Rev. Stat. Ann. tit. 36 §4102, §4102, §4119); Maryland ($5 million; *see* Md. Code Ann., Tax-Gen. §7-305, §7-309)); Massachusetts ($1 million; *see* Mass. Gen. Laws 65C §2A); Minnesota ($3 million; increasing to $3 million for 2020 and thereafter; *see* Minn. Stat. Ann. §291.005, §291.03); New York ($5.74 million (exemption amount is what the federal exemption would be prior to the 2017 tax act); *see* N.Y. Tax §952(c)(2)(B)); Oregon ($1 million; *see* Or. Rev. Stat. §118.010); Rhode Island ($1,561,719 (exemption is $1.5 million adjusted for inflation after 2015); *see* R.I. Gen. Laws §44-22-1.1); Vermont ($2.75 million; *see* Vt. St. Ann. tit. 32 §7442a); and Washington ($2.193 million; Wash. Rev. Code §83.100.020). Connecticut is the only state to impose a separate gift tax. A few additional states impose a separate inheritance tax, including Iowa, Kentucky, Maryland, Nebraska, and Pennsylvania. Maryland is the only state that imposes both an estate tax and an inheritance tax. The inheritance taxes are typically less than the separate estate taxes and/or only apply to the receipt of property by certain groups.

[14] Md. Code Ann., Tax-Gen. §7-309(b)(3)(6).

[15] §2058.

[16] Economic Growth and Tax Relief Reconciliation Act of 2001 (Pub. L. 107–16, 115 Stat. 38, June 7, 2001) (2001 Act).

[17] The 2017 tax act creates deficits. The only way to pass a bill that is deficit-burdened is for it to be passed as part of the annual budget reconciliation. However, to undo many parts, if not all, of this 2017 tax act, it would be much easier for a Democratic Congress and White House, because undoing legislation that creates a surplus just needs a simple majority in both Houses of Congress, and the legislation could be done through the use of a stand-alone

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Senate's passage, the 2001 Act was passed by a majority of the Senate and became law, but the Byrd Rule forced the sunset after 2010.

Fast forward to 2017. With the Republicans holding only 51 Senate seats, and considering the Congressional acrimony surrounding the tax legislation, 60 votes supporting the 2017 tax act was impossible; in fact, many were worried that the Republicans would not be able to garner the 50 votes needed for passage.[18] Thus, although the 2017 tax act was passed by the Senate, the Democrats invoked the Byrd Rule because the 2017 tax act affected the budget deficit within the certain parameters. As expected, the Republicans were not able to garner the required 60 favorable votes in the Senate, so the doubling of the Exclusions will sunset in 2026.

Total repeal of the estate tax continues to be alluring to some, but it is too ephemeral to warrant serious reliance. This is based on the history of the modern estate tax, where the tax was repealed for only one year out of the past 102 years, and even then, repeal was short-lived as legislation made the estate tax ''optional.''[19] Moreover, the policy of the estate tax has long been to further the social policy of breaking up large concentrations of wealth. By some measures, the United States is the most unequal first world country in terms of wealth and income inequity.[20] The core point is that it's imprudent to entrust the security of family wealth to Congressional action or inaction on the estate tax.

Use It or Lose It — the Exclusion Increase is Temporary!

The key point is that the ''doubling'' of the Exclusions is temporary (i.e., they sunset). For those that can afford to do so, using the new Exclusions sooner, rather than later, is advisable. For the analysis below, the original or ''constant'' Exclusion amount, i.e., the first $5.6 million, is referred to as the ''Original Exclusion Amount,'' and the new Exclusion granted under the 2017 tax act is referred to as the ''New Exclusion Amount.''

A concern for practitioners advocating current gifting of the New Exclusion Amount is whether the taxpayer would receive credit for its usage if, and when, the New Exclusion Amount was either repealed or sunsetted. This concept, colloquially referred to as the ''clawback,'' could have detrimental effects on the taxpayer because, if credit were not afforded for the use of the New Exclusion Amount, the calculation methodology under §2001 would impose a phantom estate tax upon the individual's death. Although it was understood from the passage of the 2017 tax act that no clawback would occur,[21] without any official statement from Treasury or the Internal Revenue Service , the clawback issue was still a possibility. Fortunately, in proposed regulations published on November 23, 2018, the Treasury clarified that the so-called ''clawback'' is not a concern.[22] If any portion of the New Exclusion Amount is used through lifetime gifts, the taxpayer will get credit for having utilized the New Exclusion Amount at the time that the gifts were made, even if the New Exclusion Amount is eliminated.[23] Note, however, that the Proposed Regulations also clarify that, in terms of the hierarchy of usage of the AEA, the Original Exclusion Amount is utilized first. This is logical because the Original Exclusion Amount will always be the constant amount, i.e., it was the amount before the 2017 tax act and will be again the amount after the 2017 tax act sunsets. Under this approach, in order to obtain the credit for any utilized New Exclusion Amount, the full amount of Original Exclusion Amount would have to be completely exhausted.

If the wealth holder survives into 2026 and has not already used the New Exclusion Amount, in terms of determining his or her transfer tax status, it will be as if the Exclusions never doubled. Considering that most Americans cannot afford to give away $11.4 million during their lifetime, it stands to reason that most individuals will receive no benefit from the New Exclusion Amount before it rolls back and is eliminated.

Therefore, the opportunity exists to reduce transfer taxes for those few wealth holders who could utilize

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bill (avoiding the budget reconciliation process and the Byrd Rule). Thus, the 2017 tax act's undoing could occur much quicker and with much less fanfare by comparison to its passing if there is a shift of power. *See* Summary of the Byrd Rule for the House of Representatives' Committee on Rules analysis of the Byrd Rule.

[18] Wait. . .why isn't this a majority? Under Article I, §3 of the Constitution, the Vice President of the United States shall be the President of the Senate, but shall have no vote, unless they be equally divided. As the tax legislation was a Republican-sponsored bill, a tie vote would mean approval as the Vice President is a Republican.

[19] *See* Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111–312 at §301.

[20] This economic disparity is more pronounced in the United States than other first world countries. *See* T. Piketty, *New Thoughts on Capital in the Twenty-First Century*, TED Talks (June 2014).

[21] *See* §11061 of the 2017 tax act, in which Congress directed Treasury to prescribe such regulations as may be necessary or appropriate to carry out §2001 with respect to any difference between the BEA applicable at the time of the decedent's death and the BEA applicable with respect to any gifts made by the decedent.

[22] Prop. Reg. §20.2010-1(c), 83 Fed. Reg. 59,343 (Nov. 23, 2018).

[23] Congress intended this result. In the Conference Committee report to the 2017 tax act, the committee stated that, ''As a conforming amendment to section 2010(g) (regarding computation of estate tax), the provision provides that the Secretary shall prescribe regulations as may be necessary or appropriate to carry out the purposes of the section with respect to differences between the basic exclusion amount in effect: (1) at the time of the decedent's death; and (2) at the time of any gifts made by the decedent.'' H.R. Rep. 115-466 (2017) . In 2012, when faced with a similar ''clawback'' issue, Treasury issued regulations in the Portability arena confirming that there would be no clawback if any deceased spousal unused exclusion amount was used. *See* Reg. §20.2010-3.

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the New Exclusion Amount by making lifetime gifts before any roll back occurs.[24] While it's unlikely that a roll back will occur before a new President could take office in January 2021, using the New Exclusion Amount as soon as possible will allow greater leverage for transfer tax purposes – e.g., all post-gift appreciation in the assets given avoids being part of the base for taxation in the wealth holder's estate.[25]

Utilization of New Exclusion Amount: More Affluent Spouse v. Less Affluent Spouse

With the above background, now consider the scenario where a married couple has a drastic disparity in wealth — one spouse holds almost all of the couple's combined wealth and such wealth exceeds the wealth holder's Exclusions. This situation might arise when neither the More Affluent Spouse nor the Less Affluent Spouse have used their respective Exclusions and now there is a concern about the roll back. Alternatively, the situation may be that the More Affluent Spouse has already used his or her Exclusions but the Less Affluent Spouse's Exclusions remain unused. Often this occurs when the More Affluent Spouse has remarried and the newer spouse has his or her full allotment of Exemptions because he or she was never in a financial condition to consider utilizing them.

In each of the above scenarios, the More Affluent Spouse realizes that, instead of wasting the Less Affluent Spouse's Exemptions, perhaps they could be put to use by transferring some of the More Affluent Spouse's wealth to his or her descendants.

Very wealthy families have learned the value of using the Exclusions of all family members, including the Less Affluent Spouses of the second, third, and more remote generations. Frequently, these spouses of the lower generations are from more modest circumstances. Many times these spouses are young. The family may desire to use such Exclusions before such lower generation couples have children. As explained below, these Exclusions have significant value, even if the in-law cannot easily make use of the Exclusions otherwise. Therefore, the family must approach this effort with caution.

A frequent objective is for the More Affluent Spouse to retain benefits and control over the gifts while still benefiting the succeeding generations. To achieve this result, all roads lead to the More Affluent Spouse creating a trust for this purpose. If a trust is to be utilized, ideally, the More Affluent Spouse would further want the trust to be structured so that he or she would pay the trust's income tax, meaning that the trust would be a grantor trust as to the More Affluent Spouse – i.e., all items of income, deduction, and credit of the trust is taxed to him or her. Such taxation allows the trust to grow in value free from income taxation, which exponentially enhances the power of compounding inside the trust.[26] Assuming that these objectives can be met, the More Affluent Spouse would like to go ''all in'' and have the trust benefit himself or herself and have spendthrift protection so that the trust is not reachable by the More Affluent Spouse's creditors.

The economics of the Less Affluent Spouse consenting to the use of his or her Exclusions should be considered. In effect, these are valuable tax breaks. This article does not address whether the Less Affluent Spouse should be compensated for allowing the use of his or her Exclusions. Each situation would be likely be unique as to whether compensation of some form is warranted and to what degree. If the planner represents both spouses, consider the impact of Rule 1.7 of the Model Rules of Professional Conduct, addressing conflicts of interest, and whether separate representation is needed.[27] Suppose that the issue of compensating the Less Affluent Spouse is never discussed and, after the plan is implemented, the couple ends their marriage. When the Less Affluent Spouse realizes that his or her Exclusions have been utilized, he or she may start to feel as if his or her generosity should have been compensated. The lawyer who represented both spouses may be an easy target for criticism.

UTILIZING THE EXCLUSION OF THE LESS AFFLUENT SPOUSE

The most efficient way to introduce and explain the techniques to utilize the Less Affluent Spouse's Exclusions is to introduce a not-so-uncommon fact pattern. In all scenarios based on the following example, any gifting or transfers occur in 2019.

Example: Henrietta's first husband, Hal, died in 2004. Henrietta has two children by Hal and no future children are expected. Henrietta married Edward in 2008. Edward has no children and $500,000 in assets. Henrietta has $50 million in assets and would like to use Edward's Exclusions for the benefit of her children by Hal. Henrietta understands portability, but she is focused on using Edward's Exclusions while the New Exclusion Amount is available, and to do so by funding lifetime GST trusts for her descendants (the ''Descendants GST Trust'').

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[24] Of course, another possibility is that Congress extends the current law and no roll back in the gift exclusion levels occurs.

[25] Maximizing the value of the exclusions might involve giving assets subject to valuation discounts and having strong growth potential. Carefully considering the gift structure is important. For example, the gift structure should mitigate the risks of the IRS complaining that the transferred asset's valuation is too low. Additional wealth transfer benefits are available by making the gifts to trusts for which wealth holder must continue to pay the income taxes.

[26] For more detail on grantor trusts, *see* Richard S. Franklin & Lester B. Law, *Extraordinary, Efficient, Elegant, Evolutionary: The Annual Taxable Gifts Approach and Testamentary CLAT Remainder*, 51st Heckerling Inst. on Est. Plan. (Jan. 11, 2017). The economic analysis included in this paper amply demonstrate the extraordinary power of using grantor trusts.

[27] *See* Model Rules of Prof'l Conduct R. 1.7 (2018).

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Split-Gifts to Henrietta's Descendants GST Trust

The easiest way to utilize a spouse's Exclusions is to engage in gift-splitting. Under this approach, assuming that Henrietta has not already used her Exclusions, she could create the Descendants GST Trust and transfer $22.8 million of her assets into it. In some situations, the split-gift election may offer a palatable solution, but, as described below, it carries some risks. The split-gift election technique is referred to as the ''Split-Gift Plan.''

Gift, Estate and GST Tax Implications to Edward

Assuming that Edward agrees to make a split-gift election on Henrietta's 2019 Form 709, U.S. Gift (and Generation-Skipping Transfer) Tax Return (the ''709''), he will be deemed to be the transferor of one-half of the assets for gift,[28] estate, and GST tax purposes. The deemed gift will use both of Edward's $11.4 million AEA and his $11.4 million GST Exemption.[29]

The Split-Gift Plan is not perfect. Suppose that the gift occurs on March 1, 2019. The split-gift election is not made until the 709 is filed for the year of the gift, which, for 2019 gifts, is not required to be filed until April 15, 2020, or October 15, 2020 if the deadline is extended. Until the 709 has been filed with Edward consenting to the split-gift election, there is no guarantee that Edward will consent to split the gift.[30] For the next 13½ calendar months (perhaps 19½ months if Henrietta elects to file her 2019 709 on extension), Henrietta is exposed to potential to gift tax liability. This may be uncomfortable for Henrietta, as much can occur over that time period. For example, what if the marriage begins to sour and Edward files for divorce by December 2019. Edward is not required to consent to split the gift, so, without the election, Henrietta would owe gift taxes of $4.56 million (($22.8 million - $11.4 million for Henrietta's AEA) x 40%)!

To protect Henrietta from this concern, she and Edward could enter into a post-nuptial agreement prior to effecting the gifts to the Descendants GST Trust. In the agreement, Edward could agree to be required to consent to the split-gift election for all of Henrietta's 2019 gifts. Of course, this raises issue of what consideration Henrietta would have to provide for Edward's agreement. Moreover, such an agreement would be subject to the typical ''best practices'' guidelines applicable to nuptial agreements, such as a full and fair disclosure by each spouse of their respective and joint assets and each spouse obtaining separate and independent legal representation.[31] These obstacles and associated costs may make such an agreement impracticable.[32]

The Split-Gift Plan would also likely be unattractive if Henrietta has already used her Exclusions. This is because Henrietta would need to make a taxable gift of $22.8 million for the split-gift election to use Edward's entire Exclusions. Henrietta, having no AEA available, would have to pay gift taxes at 40% on the one-half of the transfer of which she would be considered to be the transferor (for both gift and GST tax purposes), or $4.56 million ($11.4 million x 40%). Further, one-half of the transfer would not be exempt from the GST tax because Henrietta would not have any remaining GST Exemption to allocate to her portion of the gift. Thus, the split-gift election is frequently not scalable without triggering gift tax exposure if the spouses' remaining Exclusions are unequal in amount.

Control

With the Split-Gift Plan, Henrietta is in complete control of the Descendants GST Trust's design. She need not grant Edward any control over the assets or the trust. For example, Edward is not required to be a beneficiary of the Descendants GST Trust, or a trustee or investment manager of the trust. Moreover, it is not necessary for Edward to have any power of appointment or have any other interest or concern with the trust.

Creditors

Assuming that the trust contains a spendthrift clause (or the law of the particular jurisdiction automatically imposes spendthrift protection to third-party trusts), the assets transferred to the Descendants GST Trust would never be exposed to Edward's creditors. The fiction that he is a transferor of property is only for federal transfer tax purposes. The assets funding the Descendants GST Trust should also be protected from Henrietta's creditors because she has no beneficial interest in the trust (unless her transfers to the trust are deemed to violate her state's fraudulent or voidable transfer laws, which can be the case if it is

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[28] Reg. §25.2513-1(a).

[29] Be design, short shrift is given in this article to the split-gift election, but note that this election has a lot of nuance – *see, e.g.,* Diana S.C. Zeydel, *Gift-Splitting – A Boondoggle or a Bad Idea? A Comprehensive Look at the Rules*, 106 J. Tax'n No. 6, p. 334 (June 2007); Carmen Irizarry-Diaz, *Effective Use of the Election to Split-Gifts*, 26 Tax Mgmt. Est., Gifts & Tr. J., No. 6, p. 247 (Nov./Dec. 2001).

[30] §2513(c).

[31] Note that the requirements for nuptial agreements vary from state to state, and in most states, separate legal representation is not a requirement for a valid nuptial agreement. However, in order to reduce the likelihood of a challenge to a nuptial agreement, it is customary for each such agreement to require full financial disclosure and separate legal representation.

[32] However, to immediately reject a plan based on entering into a post-nuptial agreement should not be arbitrarily dismissed due to the costs involved. Considering the transfer tax savings generated by the Split-Gift Plan, the cost of a post-nuptial agreement should be relatively *de minimis* by comparison. However, there may be other mitigating factors that could rule out a post-nuptial agreement between the parties, such as that they may already have a prenuptial agreement in place and the discussion of a post-nuptial agreement could lead to a re-opening of negotiations involving the prenuptial agreement, which one party may not see as advantageous to him or her.

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Using LAS's Exclusions In Gift To Descendants GST Trust for MAS's Descendants

Legend:
LAS = Less Affluent Spouse
MAS = More Affluent Spouse
DAPT = Domestic Asset

	Split-Gift Plan	Marital Gift/Re-Gift Plan	Lifetime QTIP Trust Plan
1. Protected from Risks of Gift Tax Exposure	No	No	Yes
2. Scalable in Using Exclusions	Not scalable without gift tax exposure, if spouses' remaining Exclusions are unequal	Yes	Yes
3. Control by MAS	Yes – MAS controls entire arrangement (other than election)	Loss of control with outright gift to LAS	Yes – MAS controls entire arrangement (other than Gift tax release)
4. Grantor Trust As To MAS	Yes	No	Yes
5. Protected from Step-Transaction Concerns	Yes	No	Yes, with caveats
6. Allows for Donor Spouse To Be A Discretionary Beneficiary Without DAPT Structure	No	Yes	Yes, in Inter Vivos QTIP Trust Jurisdictions

determined that she intended to hinder, delay, or defraud any of her creditors).[33]

[33] Forty-four of the 51 jurisdictions have adopted either the Uniform Fraudulent Transfer Act (UFTA), as promulgated by the National Conference of Commissioners on Uniform State Law (NCCUSL) in 1983, or the more recent Uniform Voidable Transactions Act (UVTA), as promulgated by NCCUSL in 2014. Common to both Acts is §4(a)(1), which provides that a transfer made

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Grantor Trusts as to Henrietta

As an extra bonus to this plan, the Descendants GST Trust is designed as a grantor trust for income tax purposes. Because the split-gift election is only a transfer tax fiction created under the Code, it does not apply for income tax purposes. As a result, Henrietta is the grantor of the entire trust for income tax purposes. This is beneficial because Henrietta has the wealth from which to pay the income taxes.

Step-Transaction Doctrine

A concern in any multi-step planning technique is the threat that the IRS may attempt to undo the transaction by applying the Step-Transaction Doctrine. Usually, the Step-Transaction Doctrine is invoked when, for example, a taxpayer intends for a preferential tax result, but cannot achieve the result on his or her own. Instead, the taxpayer must undertake several steps to be taken not only by him or her, but by others. Case law has created the Step-Transaction Doctrine as a variation on the substance-over-form doctrine, the purpose of which is to ensure that transactions are taxed according to their substance and not their outward form; accordingly, a court will not apply the Step-Transaction Doctrine if the substance of the transaction does not differ from its form.[34]

Edward's Exclusion does not pose any concern with the Step-Transaction Doctrine. This is because the Step-Transaction Doctrine is not applicable to gift-splitting – the actions by the spouse in electing to split the gift are statutorily granted to the spouse. In other words, the Code specifically authorizes the spouse to split gifts. No additional steps are needed.

Psychological Effect to the More Wealthy Spouse of the Permanent Divesture of Assets

Creating a trust to benefit Henrietta's descendants causes the total divestiture of the transferred assets from her, meaning that she forever loses the use and benefit of the $22.8 million. For many clients, even if they have sufficient other assets whereby the gifts would not affect the client's standard of living, the thought of forever transferring $22.8 million is concerning, even if the risk is merely perceivable and not actual.

Marital Gift Followed by Re-Gift to Descendants GST Trust

Regardless of whether Henrietta has any portion, or all, of her Exclusions available, another option is for Henrietta to give Edward $11.4 million of assets. The idea would then be that, at some point in the future, Edward gifts $11.4 million to the Descendants GST Trust, or creates a new Descendants GST Trust that only benefits Henrietta's descendants. This approach is referred to as the ''Marital Gift/Re-Gift Plan.'' For many clients, this seems to be the most logical – and easiest – approach, as it would avoid the delay in confirming the split-gift. For the reasons outlined below, however, the Marital Gift/Re-Gift Plan is unlikely to be the best solution.

Estate, Gift, and GST Tax Implications to Edward

Following Henrietta's gift to Edward, he becomes the owner of the assets. Presumably, this approach envisions that Edward will be vested with full fee ownership. As such, he would become the transferor of the assets for all purposes. Upon Edward's subsequent gift to the Descendants GST Trust, Edward will be the transferor of the assets for income, gift, estate, and GST tax purposes. The subsequent gift will use Edward's $11.4 million AEA and his $11.4 million GST Exemption.

Control

With the Marital Gift/Re-Gift Plan, Henrietta can still be in complete control of the design of the Descendants GST Trust. Similar to the Split-Gift Plan, she does not need to grant any interest or control to Edward in the trust. However, following Henrietta's gift to Edward, the assets are exposed to Edward's control and he — and he alone — decides whether to give property to the Descendants GST Trust.

This plan also raises marital law implications. As an inter-spousal gift, it would likely convert the property from Henrietta's separate property to marital property or perhaps to Edward's separate property.[35]

Creditors

The assets transferred to Edward would be exposed to Edward's creditors. This is likely one of the most significant pitfalls to this approach. Consider that the assets transferred by Henrietta to Edward should be protected from Henrietta's creditors unless her transfer is deemed to be a fraudulent/voidable transfer. Likewise, Edward's subsequent gift to the Descendants GST Trust should also be protected from his creditors unless his transfer is deemed to be a fraudulent/voidable transfer. Note that under this ap-

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or obligation incurred by a debtor is fraudulent/voidable (depending on the particular act – the UFTA uses ''fraudulent'' and the UVTA uses ''voidable'') as to a creditor, whether the creditor's claim arose before or after the transfer was made or the obligation was incurred, if the debtor made the transfer or incurred the obligation with actual intent to hinder, delay, or defraud any creditor of the debtor.

[34] William W. Chip, 508 T.M., *The Economic Substance Doctrine*, III.D(1), nn. 298, 299.

[35] *For example, see* Fla. Stat. §61.075(6)(a)1.d. (''Marital assets and liabilities'' include . . . interspousal gifts during the marriage.). Other states may also deem interspousal gifts to be marital property, but do so by negative inference: *see* Va. Code §22-107.3.A.1 (''Separate property is . . . all property acquired during the marriage by gift from a source other than the other party.'') and Va. Code §22-107.3.A.2. (''Marital property is . . . all other property acquired by each party during the marriage which is not separate property as defined above.''); and N.Y. Dom. Rel. Law §236, Part B.1.d.(1) (''The term separate property shall mean property acquired before marriage or property acquired by bequest, devise, or descent, or gift from a party other than the spouse.'').

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proach, there are **two** potential fraudulent/voidable transfer inquiries.

Grantor Trust Status

Even if the other obstacles could be successfully navigated, this approach makes Edward, and not Henrietta, the grantor for income tax purposes of the portion of the Descendants GST Trust represented by Edward's contribution to the trust or of the separate Descendants GST Trust created by Edward.

This approach is not ideal because Henrietta has the wealth from which to pay the income taxes. After all, it would be preferable from Henrietta's perspective to have Edward completely removed from the plan once his Exclusions are used.

Assuming that Henrietta and Edward remain married, this does not pose that much of an inconvenience if they elect ''Married Filing Jointly'' status for their income tax returns. By doing so, Edward's portion of the income is reported on the same income tax return as Henrietta's, so Henrietta can pay the income tax without any adverse consequences. However, should they divorce, the grantor trust status for Edward becomes more problematic. Assuming that Edward's contribution was to Henrietta's Descendants GST Trust, Edward is still the grantor of the portion representing his contribution to the trust (presume that Edward's portion represents 50% of the trust). However, Edward has no individual funds from which to pay the taxes. Therefore, assuming that the trust contains an ''income tax reimbursement clause,''[36] either the trustee would have to exercise the authority and pay to Edward the income taxes owed on his share (and thereby reducing the exponential compounding associated with grantor trust status), or Henrietta would have to pay the income taxes by making annual and/or taxable gifts to Edward (which is also the only solution if the trust does not contain an income tax reimbursement clause).

Even absent a divorce, if the objectives are to utilize Edward's Exclusions and not have him involved in any other aspect of the plan, the second objective would fail because, as a grantor trust, Edward would receive the trust's 1099s reporting the trust's taxable income. This would serve as an annual reminder of Henrietta's wealth and inheritance plan (and Edward's role in allowing the use of his Exclusions). Moreover, in a divorce scenario, Edward would still be the grantor of his portion for income tax purposes and would continue to receive information about the trust.

Even without a divorce, the plan is hampered if Edward were to predecease Henrietta. Edward's death terminates the grantor trust status of Edward's portion of the trust. Prior to his death, the trust was bifurcated for federal income tax purposes, and after his death, it remains bifurcated as Edward's portion now becomes a separate taxpayer responsible for the payment of its own income taxes.

Step-Transaction Doctrine

The Marital Gift/Re-Gift Plan is almost a textbook example of the Step-Transaction Doctrine. Recall that Henrietta has excess assets and Edward has none. Henrietta gifts Edward funds that ''coincidentally'' are equal to the amount of Edward's Exclusions. Edward then, at a later date, either, (1) contributes those same funds to a trust for Henrietta's descendants, or (2) creates a trust for the benefit of Henrietta's descendants and then transfers said funds into said trust. It would appear as if the IRS would not have much difficulty in applying the Step-Transaction Doctrine to this technique by arguing that the use of Edward's Exclusions is the result of a prearranged plan between Henrietta and Edward and that the gift to Edward is a sham and should be ignored — i.e., that Henrietta, and not Edward, is the real donor of the assets to the trust for Henrietta's descendants. Further, in a second marriage situation with a prenuptial agreement, there may be negotiated provisions as to the amount of assets to be transferred by the More Wealthy Spouse to the Less Wealthy Spouse. The gift of the Less Wealthy Spouse's Exclusion amount may be more value than the Less Wealthy Spouse is entitled to receive under any circumstances by the agreement's terms. If so, this could be even more proof to the IRS that the gift to the Less Wealthy Spouse is a sham – why would someone receive $11.4 million and then divest himself of the entire amount if this weren't a prearranged plan to benefit Henrietta.

Discretionary Benefits to More Wealthy Spouse

Suppose the parties desire that, should Edward elect to transfer funds to the GST Descendants Trust, then, based on the above grantor trust issues and for easier record keeping, it is better that Edward create a separate GST Descendants Trust. In order to distinguish this transfer from the suggestion of a prearranged plan, Edward could make Henrietta a discretionary beneficiary of his Descendants GST Trust (i.e., a so-called ''spousal lifetime access trust'', or SLAT). Assuming the other concerns can be resolved favorably, this is an advantage of the Marital Gift/Re-Gift Plan over the Split-Gift Plan because, as a beneficiary of the SLAT, Henrietta now has access to the funds. Instead of losing full control and access over $22.8 million, she has only lost full control and access of $11.4 million because she is now a beneficiary of the trust holding the other $11.4 million. Further, Edward can argue that he is still receiving some benefit from the funds, for if distributions are made to Henrietta, he is an indirect recipient of the distribution as a member of the marital unit.

[36] Often, a grantor trust will include an ''income tax reimbursement'' clause, which allows the trustee of the trust to reimburse the grantor for the income taxes owed by the grantor as a result of the grantor trust status of the trust. Note that where the trustee of an irrevocable trust that is a grantor trust reimburses the grantor for the amount of the income tax attributable to the inclusion of the trust's income in the grantor's taxable income, as required or permitted under the trust's governing instrument or applicable state law, the trust beneficiaries are not treated as making a gift of the amount of the income tax to the grantor. *See* Rev. Rul. 2004-64. Further, some states specifically provide that such reimbursement is not an amount that is ''distributed to or for the settlor's benefit'' and therefore is not attachable by the settlor's creditors. *See* Va. Code §64.2-747.A.2.; Fla. Stat. §736.0505(1)(c).

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Lifetime QTIP Trust Plan

The third option does not involve outright gifts to the Less Wealthy Spouse and nor does it involve much dependency on elections by the Less Wealthy Spouse, and yet it accomplishes all of the intended goals of the More Wealthy Spouse. The third option involves a Lifetime QTIP Trust that could be used to establish a controlled plan to use Edward's Exclusions during his lifetime or upon his death while still affording Henrietta the control and access that she desires. The Lifetime QTIP Trust also has the advantage of availability regardless of whether Henrietta has any, or all, of her Exclusions available. This technique is referred to as the ''Lifetime QTIP Trust Plan.''

The Lifetime QTIP Trust Plan begins with Henrietta funding a Lifetime QTIP Trust with $11.4 million (the amount equal to Edward's Exclusions). So far, nothing out of the ordinary.

The next element involves the QTIP election. While the election is made on the timely-filed 709,[37] the key to the election involves the GST tax.

Under the basic GST tax rules, §2652(a)(1) generally provides that, in the case of property that is subject to the estate tax or the gift tax, the decedent or the donor, as the case may be, is the ''transferor'' for GST tax purposes. It is the transferor who determines the GST tax status of a transaction and it is the transferor's GST Exemption that is applied against property that is subject to the GST tax. With a QTIP election, while the property is subject to the marital deduction for the donor/decedent, upon the death of, or lifetime disposition by, the spouse, §2044 and §2519, respectively, subject the property to the estate or gift tax at the time of the death/disposition.[38] Upon such transfer tax imposition, under the definition in §2652(a)(1), the spouse becomes the transferor for GST tax purposes (and therefore, the spouse's GST Exemption would be applied).

In most instances, when creating a lifetime or testamentary QTIP trust, if the donor has any remaining GST Exemption, the donor (if lifetime) or the donor's executor (if testamentary) would elect under §2652(a)(3) to treat the donor or the decedent, as the case may be, as the transferor for GST tax purposes (referred to as the ''Reverse-QTIP Election''). As a result of the Reverse-QTIP Election, a fiction is created whereby the donor/decedent remains the transferor for GST tax purposes even though the property will eventually be subject to transfer tax upon the death of, or disposition by, the spouse. However, with the Lifetime QTIP Trust Plan, regardless of whether she has any remaining GST Exemption, Henrietta would not make the Reverse QTIP Election. This way, under the general GST tax rules, Edward would become the transferor of the trust for GST purposes when he either dies or releases his interest in the trust.[39]

A benefit of this approach is that it scalable to either of the Exclusions or both. Suppose that Henrietta inadvertently transfers property to the Lifetime QTIP Trust in excess of Edward's available GST Exemption (which could easily have occurred if it is later determined that Edward had previously used a portion of his GST Exemption). For example, Henrietta transfers $11.4 million into the Lifetime QTIP Trust on the premise that Edward has his full $11.4 million GST Exemption available; however, it is later determined that, in his prior marriage, Edward consented to a gift with his former spouse and had utilized $1 million of his GST Exemption. When making the QTIP election, if she still has GST Exemption available, Henrietta can make the Reverse QTIP Election but do so by a formula, so that the Reverse QTIP Election only applies to the fractional amount transferred into the Lifetime QTIP Trust equal to the excess of the amount transferred over Edward's available GST Exemption.[40]

Gift, Estate, and GST Tax Implications to Edward

As a QTIP trust, upon Edward's death, the value of the trust would be included in his Gross Estate under §2044, and, as described above, he would become the transferor of the trust's assets for GST tax purposes (this is the effect of Henrietta's not having made the Reverse-QTIP Election). As such, Edward's Exclusions would be used upon his death.

Alternatively, at some point after the Lifetime QTIP Trust is funded, Edward could release his interests. For example, if Edward became concerned that his New Exclusion Amount should be used in the near future rather than risk it being eliminated by a roll back in the Exclusion amounts, one possibility is that he could release his interests in the Lifetime QTIP Trust. No agreement or obligation to do so should be imposed on Edward at the time the Lifetime QTIP Trust is established. If Edward entirely releases his interests in the Lifetime QTIP Trust,[41] he would be treated as

[37] A great deal of caution is warranted in ensuring that a gift tax return is timely filed and the QTIP election is made because the IRS believes that it does not have discretion to grant a request for an extension of time to make the gift QTIP election. *See* Ubiquitous, n. 8, above, at ¶ 1600.2.A.

[38] For a more detailed analysis of the working of §2519 with respect to lifetime dispositions of QTIP property, *see* Richard S. Franklin and George D. Karibjanian, *Portability and Second Marriages – Worth a Second Look*, 39 Tax Mgmt. Est. Gifts & Tr. J., No. 5, p. 179 (Sept./Oct. 2014) (Second Look).

[39] Because the Lifetime QTIP Trust Plan contemplates the full use of Henrietta's GST Exemption, it is unlikely that she would be able to make the Reverse QTIP Trust election; it is nevertheless important in understanding each element of the Lifetime QTIP Trust Plan to emphasize why the election, even if available to Henrietta, would not be made.

[40] If Henrietta does not have any GST Exemption available, the trustee of the Lifetime QTIP Trust would likely undertake to sever the trust upon funding, or, if at a later date, undertake a qualified severance under §2642(a)(3) in order to create two trusts, one of which has a GST tax inclusion ratio of one and the other of which has a GST tax inclusion ratio of zero.

[41] Care must be exercised to ensure that Edward may release his interests. A typical spendthrift clause may prohibit a release.

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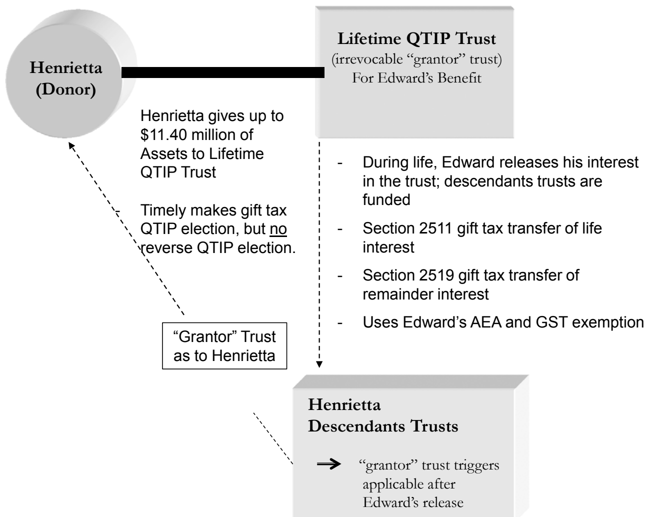
having made a gift of 100% of the QTIP property.[42] Edward's release would trigger a gift of his income interest under §2511 and the entire value of the remainder interest under §2519. The gifts triggered by the release would consume Edward's AEA and permit his GST Exemption to be allocated to the Lifetime QTIP Trust. The Lifetime QTIP Trust would then become the Descendants GST Trust for Henrietta's descendants.

This plan is illustrated as follows:



The result almost seems too foolproof to succeed. The question that must be asked is whether Edward can subsequently disrupt the plan. The key to this analysis is that the Lifetime QTIP Trust eventually uses Edward's GST Exemption; ''eventually'' because his GST Exemption will not be allocated until he either dies or releases his interest.

Attention must be given to §2632 regarding the special rules for allocation of GST Exemption. After the GST tax had been introduced in 1986, certain events created a GST tax scenario that was not originally contemplated under Chapter 14 of the Code. For example, suppose that an individual created an irrevocable life insurance trust, providing that, upon his or her death, the trust would be distributed outright to his or her three children, per stirpes. The trust then purchased a term life insurance policy on the settlor's life. Based on a pure life expectancy analysis, the settlor should predecease the children, who would receive the proceeds outright. Further, the fact that the term policy could be terminated without detrimental tax costs to anyone meant that it was not viewed as a viable asset to pass down to subsequent generations. As a result, the ''best practices'' at the time was to not allocate GST Exemption to transfers to the trust, so that such exemption could be better used against other assets that pass to successive generations. What happened, however, if a child predeceased the settlor and left surviving descendants? Upon the settlor's death, the deceased child's share would pass directly to the grandchildren, which is the appearance of a direct skip under §2612(c). Further, this was not a situation where the ''predeceased parent'' rule of §2651(e)(1) would apply because the ''predeceased parent'' rule only applies at the time that the estate or gift tax is imposed, and with the irrevocable trust, the gift tax would have been imposed when the contributions were made to the trust and not upon the settlor's death. Therefore, if the trust were to be protected from the GST tax, a ''late allocation'' would occur at the settlor's death, and if no GST Exemption was otherwise available, this would result in the imposition of a GST tax.[43]

To correct this, Congress expanded the ''automatic allocation'' rules in §2632. After enactment, certain transfers that involved direct skips or certain trusts would have the transferor's GST Exemption ''automatically allocated'' to such transfers, thereby protecting them from an inadvertent GST tax. What if taxpayers did not want such automatic allocation? Congress addressed this by enacting §2632(b)(3) and §2632(c)(5), which allows taxpayers to ''opt out'' of automatic allocation for such direct skips and transfers to trusts, respectively. Because the Lifetime QTIP Trust Plan does not involve direct skips, the focus will be on the certain transfers in trust. If a transferor were to elect to ''opt out'' of the automatic allocation rules for such trusts, §2632(c)(5)(B) requires that such ''opt out'' be elected on a timely filed 709.

With this background, suppose that Edward wanted to disrupt the plan, and he determines that the best way to do this is by not allocating his GST Exemption. Can he do this?

The first scenario is that Edward dies without having released his life interest in the Lifetime QTIP Trust. Based on the literal provisions of §2632(c)(5), even if his personal representatives/executors wanted to ''opt out,'' they would be prohibited from doing so because, as stated above, §2632(c)(5)(B) provides that any election to ''opt out'' must be contained in a 709. Edward has died and the transfer is reported on his 706 and not a 709, so the ''opt out'' is not possible. What if no allocation is made on Edward's 706 or if no 706 is filed on Edward's behalf (which could occur if the value of the Lifetime QTIP Trust is less than Edward's available AEA)? Unless Edward has subsequently obtained significant other assets and has left them to skip persons, the result is the same because Edward's GST Exemption is automatically allocated to the Lifetime QTIP Trust pursuant to §2632(e).

The second scenario is that Edward releases his life estate, thereby causing gift tax recognition under §2519. This could present a problem, as §2519 transfers are reported on a 709. When the release occurs, Edward would become the transferor, and, as it is his GST Exemption in play, the provisions of §2632 are applicable to him. Thus, it is possible that he could ''opt out'' of automatic allocation in this instance. To

To avoid this concern, specifically allow a release by the donee spouse as distinct from an assignment. *See* Ubiquitous, n. 8, above, at ¶ 1602.4.

[42] §2519. *See* Ubiquitous, n. 8, above, at ¶ 1600.2.B.

[43] *See* Reg. §26.2632-1(d)(1).

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prevent this result, a nuptial agreement may be required to bind Edward to not ''opt out'' if he were to release his interest; but, as stated previously, to proceed in this manner may cause other issues, such as negotiating a cost with the Less Wealthy Spouse for the ability to bind him or her to the GST Exemption allocation.

Control

The Lifetime QTIP Trust Plan allows Henrietta's design of the Lifetime QTIP Trust to control the management and disposition of the assets at all times. It is not necessary for Henrietta to grant Edward any control over the trust. Moreover, Edward is not required to be a trustee or investment manager, or be granted any power of appointment. Other than his income interest, Edward has only one other influence over the trust, which is to decide whether to release his interests in the trust during his lifetime thereby triggering the transfer tax. Of course, this control means that Edward could keep the lifetime QTIP interest, which by design must be structured to continue for his lifetime even in the event of their divorce. Nevertheless, on Edward's death or release of his trust interest, the principal passes to the Descendants GST Trust, so Henrietta will have succeeded in transferring the wealth downward for the benefit of her descendants.

Creditor Protection

The assets transferred to the Lifetime QTIP Trust can be protected from Edward's creditors by structuring the trust as a spendthrift trust. The assets funding the Lifetime QTIP Trust should also be protected from Henrietta's creditors if the transfer to the trust is not a fraudulent/voidable transfer because she has no interest in the trust.

Continuing Grantor Trusts as to Henrietta

Another significant advantage of this approach is that, after Edward's death or lifetime release of his income interest, the remaining trust assets can continue in trust for the benefit of Henrietta's descendants. While Henrietta is living, such trusts will be grantor trusts as to Henrietta.

Upon creation, because the trust income is paid to Edward, who, at the time of the creation of the Lifetime QTIP Trust, is married to Henrietta, the trust is a grantor trust as to Henrietta under §677(a)(1).[44] However, reliance should not be solely placed on this provision of the law, as upon Edward's death, grantor trust status would terminate. Therefore, the trust instrument should also contain other grantor trust triggers, such as the power of any person (including the grantor) to reacquire trust assets by substituting other property of equal value (§675(4)(c)) or the ability in the grantor to borrow from the trust without adequate interest or security (except where the trustee has a general lending power to make loans to any person without regard to interest or security) (§675(2)). Assuming that Henrietta is living when Edward dies or releases his interest in the trust, this would allow the continuing trusts for Henrietta's descendants to also be grantor trusts as to Henrietta. Enabling the assets to be retained in grantor trusts as to Henrietta is a significant income tax advantage over Henrietta simply giving funds to Edward to make gifts in the future to trusts for Henrietta's descendants. The income tax treatment as to Henrietta is completely independent of the transfer tax treatment; Henrietta remains the grantor of any continuing trust for her children's benefit under the grantor trust rules, even though Edward's release of his interests in the Lifetime QTIP Trust makes him the transferor for gift and GST tax purposes. This result is reliant upon the language of Reg. §1.671-2(e)(5), which provides:

> If a trust makes a gratuitous transfer of property to another trust, the grantor of the transferor trust generally will be treated as the grantor of the transferee trust. However, if a person **with a general power of appointment over the transferor trust** exercises that power in favor of another trust, then such person will be treated as the grantor of the transferee trust, even if the grantor of the transferor trust is treated as the owner of the transferor trust under subpart E of the Internal Revenue Code. (emphasis added.)

Pursuant to this Regulation, a change in grantor for income tax purposes occurs only if someone possesses a general power of appointment over the transferor trust and actually exercises it in favor of another trust. In the example above, Edward would not hold a general power of appointment over the Lifetime QTIP Trust and therefore Henrietta will remain the grantor of the trust for income tax purposes after Edward's release of his interests in the trust.[45]

Step-Transaction Doctrine

A caveat to this plan is to consider any possible application of the Step-Transaction Doctrine.

If Henrietta creates the Lifetime QTIP Trust and Edward immediately releases his interest in the trust,

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[44] Under §677(a)(1), the grantor is treated as the owner of any portion of a trust whose income, without the approval or consent of any adverse party, is, or, in the discretion of the grantor or a nonadverse party, or both, may be distributed to the grantor or the grantor's spouse. However, in designing the Lifetime QTIP Trust it is necessary to consider the post-divorce income tax implication of the trust, as §672(e)(1)(A) defines a ''spouse'' as any individual who was the spouse of the grantor at the time of the creation of such power or interest. Therefore, even if a divorce occurs, the former spouse is still the ''spouse'' of the grantor spouse for purposes of the grantor trust rules. *See* Ubiquitous, n. 8, above, at ¶ 1600.5.B; Barry A. Nelson & Richard S. Franklin, *Inter Vivos QTIP Trusts Could Have Unanticipated Income Tax Results to Donor Post-Divorce*, LISI Est. Plan. Newsletter, #2244 (Sept. 15, 2014). New concerns have arisen as a result of the 2017 tax act, which repeals §682 for divorces occurring after Dec. 31, 2018. *See* George D. Karibjanian, Richard S. Franklin & Lester B. Law, *Alimony, Prenuptial Agreements, and Trusts under the 2017 Act*, 43 Tax Mgmt. Est., Gifts & Tr. J. , No. 3, p. 155 (May/June 2018).

[45] *See* Deathbed Lifetime QTIP.

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the IRS might argue that this was part of a preconceived plan whereby Henrietta was actually making a gift to her descendants, which would mean that, (1) Edward's AEA cannot be used to shelter the Lifetime QTIP Trust from transfer taxation, and (2) Henrietta, rather than Edward, is the transferor for GST tax purposes. The good news is that the Code provides a defense in connection with a Lifetime QTIP Trust. Section 2523(f)(1)(B) provides that, ''for purposes of subsection (b)(1), no part of such property shall be considered as retained in the donor or transferred to any person other than the donee spouse.'' Thus, the Code states that, with respect to a transfer to a Lifetime QTIP Trust, the donor spouse, i.e., Henrietta, has not retained an interest in the trust. Therefore, it would seem implausible for the Step-Transaction Doctrine to be applied to argue that the Henrietta retained an interest in the trust when the ''black letter of the law'', i.e., the Code, clearly states otherwise.[46] Moreover, under the Step-Transaction Doctrine, the donor spouse would have necessarily transferred something to someone other than the donee spouse, and §2523(f)(1)(B) provides that such a result shall not be considered to have happened.

These statutory and regulatory deeming rules provide a basis for argument not present in the typical Step-Transaction Doctrine case. For example, in *Linton v. United States,*[47] the controversy concerned whether LLC membership interests were given or whether the gift was of the LLC's underlying assets. The U.S. Court of Appeals for the Ninth Circuit held that the Step-Transaction Doctrine applied if all of the elements of at least one of three tests are satisfied: (1) the ''end result test'' (i.e., a series of steps taken to reach a particular result), (2) the ''interdependence test'' (i.e., questions whether each step useful in its own right or just as part of the series of steps, and is each step commercially reasonable), or (3) the ''binding commitment test'' (i.e., applies to transactions over several years where there was a binding commitment to complete the later steps at the time of the earlier steps). The *Linton* court found none of the tests applicable.

While giving due regard to the technical argument noted above, it is still ''best practices'' to not ''hard wire'' the future release (i.e., plan to fail the ''end result test''). Instead, a reasonable amount of time should pass between the funding of the Lifetime QTIP Trust and the Less Wealthy Spouse's release to demonstrate that the release is truly the free act of the Less Wealthy Spouse (i.e., plan to fail the ''binding commitment test''). A few years would be best; if possible, perhaps the Less Affluent Spouse should wait for the applicable statute of limitations to run on the 709 on which the QTIP election is made. Of course, a possible roll back in the Exclusions in the event of a change in the government may influence the Less Affluent Spouse to release earlier in time, but a release based on the roll back of the Exclusions provides more support for an independent decision to release and not a preconceived plan. Note that the gift tax QTIP election, once made on the 709, is irrevocable.[48] Therefore, this provides further support for the proposition for waiting for the release until after the QTIP election becomes irrevocable.

The possible release should be one of several options available to the donee spouse (i.e., plan to fail the ''interdependence test''). Consider that if there were a preconceived plan, this could be considered to be a restriction on the income interest, and any limitations on the donee spouse's income interest for life would likely jeopardize the marital deduction. Therefore, the More Affluent Spouse enters this arrangement with the knowledge that the Less Affluent Spouse may continue the Lifetime QTIP Trust arrangement for life and may never release his or her interests during lifetime to trigger the gift. This risk is mitigated by the fact that the Lifetime QTIP Trust will eventually use the Less Affluent Spouse's Exclusions upon his or her death (which cannot definitely be stated with respect to a release), and that the only mandatory distributions (i.e., required by the QTIP rules) would be of trust income to the Less Affluent Spouse.

One suggestion to mitigate the possibility of a successful application of the Step-Transaction Doctrine is to make the split-gift election for the calendar year in which the QTIP election is made. Pursuant to §2513(a)(1) and Reg. §25.2513-1(b)(4), a gift made by a spouse is eligible for split-gift treatment except for a gift made to the other spouse. Earlier in this article, it is stated that, pursuant to §2523(f)(1)(B), no part of QTIP property can be considered as retained in the donor or transferred to any person ''other than the donee spouse.'' So, if QTIP property is considered to be retained by the donor and is not a transfer to any person other than the donor's spouse, QTIP property is necessarily deemed to be a gift made to the spouse. Therefore, the split-gift election is not available for transfers to QTIP trusts. On the other hand, despite §2523(f)(1)(B), if the IRS is successful in arguing the Lifetime QTIP Trust is a sham under the Step-Transaction Doctrine and that all transferred property passed to beneficiaries other than the donee spouse, the split-gift election ought to then be available. Once the split-gift election is made it applies to all property transferred during that particular year (i.e., all property other than what is given to the spouse).[49] In effect, a best-case scenario is the split-gift election is disregarded; in a worse-case scenario, the split-gift election limits the taxable gift by the More Affluent Spouse to one-half of the transfer. This means that

[46] Section 2523(f)(1)(B) has meaning outside just ''subsection (b)(1).'' This is illustrated in Exs. 10 and 11 of Reg. §25.2523(f)-(1)(f) with respect to retained interests in resulting trusts from an inter-vivos QTIP trust and the conformation that such interests are not subject to gross estate inclusion under either §2036 and §2038.

[47] *See, e.g.*, *Linton v. United States*, 630 F.3d 1211, 1224 (9th Cir. 2011).

[48] §2523(f)(4)(B).

[49] Reg. §25.2513-1(b).

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even in this fail-safe situation, the More Affluent Spouse will be in approximately the position that would have been available with the scenario outlined above for the Split-Gift Plan.

Enhanced Benefits to More Wealthy Spouse

It was previously stated that the More Wealthy Spouse would not have a beneficial interest in the Descendants GST Trust. This may not always be the case. Depending on the jurisdiction of the More Wealthy Spouse, the Lifetime QTIP Trust can provide a particular extra benefit in terms of creditor protection in the form of a resulting trust for the benefit of the More Wealthy Spouse. To truly understand the benefit of this approach, some background must be provided on the ''domestic asset protection trust'', or DAPT.

A DAPT is, simply put, a self-settled irrevocable trust wherein income and/or principal may be distributed, as the trustee's discretion, to the settlor. Under the more modern ''self-settled spendthrift trust'' doctrine, regardless of whether a trust contains a spendthrift clause, the settlor's creditors can reach the maximum amount from the trust that can be distributed to or for the settlor's benefit.[50] Prior to 1997, in order to achieve creditor protection within a self-settled irrevocable trust, individuals would often create an ''asset protection trust'' in certain off-shore jurisdictions such as Bermuda or the Cayman Islands. In 1997, however, Alaska became the first state to enact legislation authorizing a ''domestic'' asset protection trusts. As of the date of this article, DAPT legislation has been enacted in 17 jurisdictions.[51]

In certain jurisdictions, it may be possible to obtain the benefits from a DAPT even if the jurisdiction has not adopted DAPT legislation. Reg. §25.2523(f)-(1)(f), Exs. 10 and 11, provide that, if the donee spouse of a Lifetime QTIP Trust predeceases the donor spouse, and the Lifetime QTIP Trust provides that a trust is to then be created to benefit the donor spouse (the ''Resulting Trust''), the Resulting Trust will not be included in the donor spouse's Gross Estate upon the donor spouse's death under either §2036 or §2038. However, what the Regulation does not consider is the effect of creditors on the Resulting Trust. Because, (1) pursuant to the self-settled spendthrift trust doctrine cited above, a settlor's creditors can reach any amounts in a trust created by the settlor that could be distributed for the settlor's benefit, and (2) the Resulting Trust is created in a trust that was created by the settlor, it would appear that the settlor's creditors can reach the assets held in the Resulting Trust, and, if so, this could cause Gross Estate inclusion under §2041. To prevent this unintended result, 11 non-DAPT states have enacted legislation (referred to herein as ''Quasi-DAPT Legislation'') preventing this result by stating that, in the Resulting Trust scenario described above, solely for creditor purposes, the settlor of the Resulting Trust is deemed to be the settlor's spouse and not the settlor.[52] The requirement of these statutes is that the Resulting Trust must have been created under a trust that qualified for the gift tax marital deduction under §2523(f). Of additional interest, in nine of the Quasi-DAPT states, the protection is only afforded to a Resulting Trust created upon the death of the settlor's spouse. In Maryland and Michigan, however, the death of the settlor's spouse is not a requirement; in those two states, the same result can be achieved with a lifetime release by the settlor's spouse of his or her interest.

If Henrietta lives in either a DAPT or Quasi-DAPT jurisdiction, the Resulting Trust following Edward's death could include Henrietta as a discretionary beneficiary. It is important to recognize that these special statutes allow an exception to the rule against self-settled spendthrift trusts, but without the trust rising to the level of being considered DAPTs in the common understanding. These statutes, along with the QTIP regulations, prevent the retained interest rules of §2036, §2038 and §2041 from being applicable at Henrietta's death.[53]

CONCLUSION

A Lifetime QTIP Trust might be the best solution to using the Less Affluent Spouse's Exclusions. The

[50] The ''self-settled spendthrift trust'' doctrine has been codified by NCCUSL as §505(a)(2) of the Uniform Trust Code, as last revised in 2010.

[51] The DAPT states are: Alaska (Alaska Stat. §34.40.110); Delaware (12 Del. C. §3570 – §3576); Hawaii (Haw. Rev. Stat. §554G et. seq.); Michigan (Mich. Comp. Laws §700.1041 – §700.10502); Mississippi (Miss. Code Ann. §91-9-701 – §91-9-723); Missouri (Mo. Rev. Stat. §456.5 – §505); Nevada (Nev. Rev. Stat. §166.010 – §170); New Hampshire (N.H. Rev. Stat. Ann. §564-D.1 – §18); Ohio (Ohio Rev. Code Ch. 5816); Oklahoma (Okla. Stat. tit. 31, §10 – §18); Rhode Island (R.I. Gen. Laws 18-9.2); South Dakota (S.D. Codified Laws §55-16-1 – §16); Tennessee (Tenn. Code Ann. §35-16-101 – §35-16-112); Utah (Utah Code §25-6-13); Virginia (Va. Code Ann. §64.2-745.1 – §64.2-745.2); West Virginia (W. Va. Code §44D-5-503A – §44D-5-503B); and Wyoming (Wyo. Stat. Ann. §47-10-502).

[52] *See* Ubiquitous, n. 8, above, at ¶ 1602.1.C and Appendix at ¶ 1603. The Quasi-DAPT jurisdictions are: Arizona (Ariz. Rev. Stat. §14-10505(E)); Arkansas (Ark. Rev. Stat. §28-73-505(c)); Florida (Fla. Stat. §736.0505(3)); Kentucky (Ky. Rev. Stat. Ann. §386B.5-020(8)(a)); Maryland (Md. Code, Est. & Trusts §14.5-1003); Michigan (Mich. Comp. Laws §700.7506(4)); North Carolina (N.C. Gen. Stat. §36C-5-505(c)); Oregon (Or. Rev. Stat. §130.315(4)); South Carolina (S.C. Code Ann. §62-7-505(b)(2)); Texas (Tex. Prop. Code §112.035(g)); and Wisconsin (Wisc. Stat. Ann. §701.0505(2)(e)).

[53] *Id.* at ¶ 1602.1. If Henrietta does not live in a DAPT or Quasi-DAPT jurisdiction, the issue may become more problematic, especially if Henrietta's domiciliary state has enacted the UVTA without excepting out certain comments. *See* George D. Karibjanian, Richard W. Nenno and Daniel S. Rubin, *The Uniform Voidable Transactions Act: Why Transfers to Self-Settled Spendthrift Trusts by Settlors in Non-APT States Are Not Voidable Transfers Per Se*, 42 Tax Mgmt. Est., Gifts & Tr. J., No. 4, p. 173 (July/Aug. 2017); George D. Karibjanian, Gerard ''J.J.'' Wehle and Robert L. Lancaster, *A Memo to the States - The UVTA Is Flawed. . . So Fix It!!!*, LISI Est. Plan. Newsletter #367 (May 1, 2018).

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other approaches carry significantly more risk, the potential the loss of control by the donor spouse, and/or continued involvement by the Less Affluent Spouse. Under the Lifetime QTIP Trust Plan, the donor spouse can retain control over the assets, creditor protection, and continued grantor trust status after the gift occurs. Most importantly, the Less Affluent Spouse's control is minimized and, when properly structured, the donor spouse may be a beneficiary of the trust following the termination of the donee spouse's interests without causing estate tax inclusion in the donor spouse's estate.

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