

Inter Vivos Tennessee QTIP Trusts

A substantial benefit can be obtained by making a lifetime gift of the applicable exclusion amount because appreciation of the gifted property between the date of the gift and the donor's death can escape the transfer tax base. A lot of Tennesseans are unwilling to make such a gift because it will require the current payment of Tennessee gift taxes. A Tennessee QTIP Trust provides an opportunity for making a lifetime gift of the applicable exclusion amount without paying Tennessee gift tax. A Tennessee QTIP Trust is a lifetime marital trust that would qualify for the federal QTIP Trust deduction but for which the donor elects not to take the deduction on the federal gift tax return. The donor does make the QTIP Trust election on the Tennessee gift tax return. There is no requirement that a federal QTIP Trust election be made in order to qualify for the Tennessee QTIP Trust election.

Rather than requiring income to be paid to the spouse, the spouse should be given the right to withdraw income. Any income that is not withdrawn by the spouse should be converted to principal at the end of the year. This qualifies for the marital deduction under Treas. Reg. § 25.2523(e)-1(f)(8). The spouse should also be given the right to withdraw principal to the extent that income is less than 5%. To the extent the amount of income not withdrawn at the end of the year exceeds 5% of the value of the trust assets on such date; the trust should require any such excess income to be distributed. This will prevent the donee spouse from becoming a partial grantor of the trust which would result in a portion of the trust being includable in the donee spouse's estate under Code § 2036 upon his or her death.

There are two benefits from using the right to withdraw income as opposed to the mandatory payment of income. First, to the extent income remains in the trust, it will escape federal transfer taxes. The second benefit is that during the period the donee spouse survives the donor spouse, the donee spouse will be required to pay federal income taxes attributable to trust income even though the income remains in the trust. Thus, the trust is able to grow in value on a pre-tax basis.

Under Code § 678(a)(1), the donee spouse will be taxed on all trust income whether or not withdrawn. Furthermore, under Code § 678(a)(2), the donee spouse will gradually become the grantor of trust principal to the extent the powers to withdraw income and principal lapse. Under the IRS view, the donee spouse will become the grantor over 5% of trust principal after one year, 9.75% after two years, 14.26% after three years, etc. As the donee spouse gradually becomes the

grantor of the trust, he or she will be able to pay tax on a greater portion of the capital gains of the trust in addition to paying tax on all of the ordinary income of the trust.

During the donor spouse's lifetime, the trust will be grantor trust as to ordinary income under Code § 677. Capital gains will also be taxed to the Grantor if the Trustee has discretion to pay principal to the donee spouse. This will allow the trust to be taxed on all trust income, including capital gains, and will allow certain transactions to occur between the donor and the Trust (such as installment sales of discounted assets) without incurring adverse income tax consequences.

The donor should not have a successor life estate or discretionary principal interest following the death of the donee spouse. This would cause inclusion under Code § 2036. The trust agreement should contain an "Upjohn" provision precluding income or principal distributions that will discharge the donor's support obligations.

The downside with a Tennessee QTIP Trust occurs when the donee spouse predeceases the donor. If the value of the trust upon the donee spouse's death exceeds the Tennessee inheritance tax exemption (currently \$1 million), the donee's estate will incur Tennessee inheritance tax. This means that some transfer tax will be paid prior to the death of the survivor. Because the lifetime Tennessee QTIP Trust will exhaust the donee spouse's Tennessee inheritance tax exemption, the donee spouse's Will should establish a testamentary Tennessee QTIP Trust for the donee's applicable exclusion amount (as opposed to a traditional credit shelter trust). Due to the potential Tennessee inheritance tax upon the death of the donee, and the necessity of the donee's establishment of a testamentary Tennessee QTIP Trust, the lifetime trust should be established by the spouse with the longest life expectancy. This will also result in the longest period for accelerating the use of the applicable exclusion amount.