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Integrated Wealth Management
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White Paper:

Qualified Terminable Interest Property Trusts

www.selectportfolio.com • Toll Free 800.445.9822 • Tel 949.975.7900 • Fax 949.900.8181

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Qualified Terminable Interest Property Trusts Overview

Summary

In general, transfers of property between spouses can be made federal gift and estate tax free under the unlimited marital deduction. However, transfers of terminable interests to spouses are disqualified from the marital deduction. A terminable interest is one that terminates or fails at a certain time or upon an occurrence or lack of occurrence of a certain event or contingency. A QTIP trust is an exception to this rule.

A QTIP trust is used when a spouse or both spouses want property of the first spouse to die to qualify for the marital deduction and provide lifetime income to the surviving spouse, but also want that property to be preserved and ultimately passed on to other beneficiaries.

What is a QTIP trust?

A QTIP trust (also called a marital deduction trust) is an irrevocable marital trust used to ensure that a decedent's property will provide lifetime income to his or her surviving spouse and then pass to other beneficiaries. A QTIP trust qualifies for the unlimited marital deduction, allowing the surviving spouse to use his or her federal gift and estate tax exemption (also called the applicable exclusion amount--$2 million in 2008) and/or federal generation-skipping tax exemption (same amount as the applicable exclusion amount).

A QTIP trust is designed to transfer property free of transfer taxes under the marital deduction just as an outright transfer would. The result, as in an outright transfer, is that the property will then be subject to taxes in the surviving spouse's estate, but can be offset to the extent of the surviving spouse's available exemption(s). Another advantage of a QTIP trust is that the property does not pass outright to the surviving spouse--it passes to an independent trustee who controls and manages the property on behalf of the surviving spouse for his or her life, and then passes to beneficiaries (typically children and grandchildren) named by the first spouse to die.

How does a QTIP trust work?

QTIP trust requirements

To qualify QTIP trust property for the marital deduction, the following four requirements must be met:

1. The trust must direct that all income earned by the trust assets be distributed to the surviving spouse at least annually

Caution: The trust document should not contain a provision that terminates the non-grantor spouse's income interest in the event of divorce.

2. The trust must direct that no person, including the surviving spouse, can appoint any part of the trust property to anyone other than the surviving spouse during the surviving spouse's lifetime

Caution: The trust document should not grant a power of appointment to the grantor spouse, even if the power would only be exercisable after the death of the non-grantor spouse.

3. Assets remaining in the trust at the surviving spouse's death must be included in the surviving spouse's gross estate for estate tax purposes
4. A QTIP election for all or a portion of the property funding the trust must be timely made on the grantor spouse's gift or estate tax return, whichever is the case.

Caution: Once made, the QTIP election is irrevocable.

The surviving spouse can be given access to principal, but that is not required. At the surviving spouse's death, the remaining assets in the trust pass to the beneficiaries who were named by the first spouse to die.

Funding a QTIP trust

Typically, a QTIP trust is created and funded at death by the decedent's will or living trust, though it can be funded during life. If the QTIP trust is funded during life, a provision can be included in the trust document directing that in the event the non-grantor spouse dies first, the annual income will be payable to the grantor spouse.

Since the surviving spouse must receive the income interest from the QTIP trust to qualify for the marital deduction, the trust must be funded with some income-producing property that is "consistent with the property's value."

Caution: Careful consideration should be made before funding a QTIP with qualified retirement plan or IRA proceeds. This can result in distributions starting sooner, larger distributions during the surviving spouse's lifetime, potentially higher income taxes on the benefits paid, and the possible loss of a life expectancy payout.

Naming a trustee

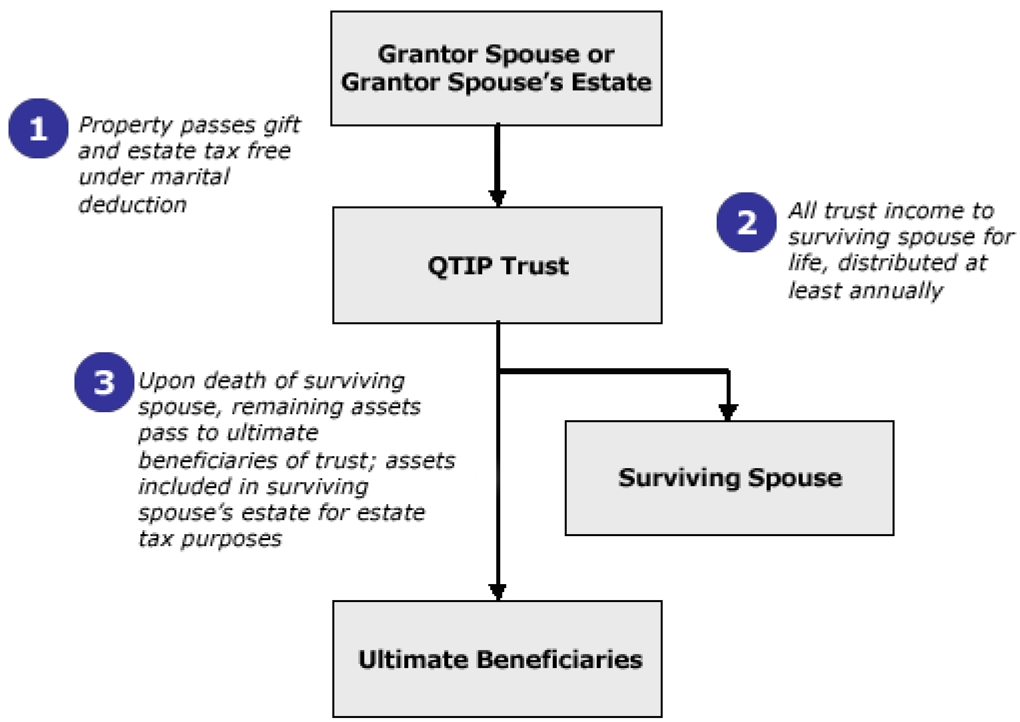
The grantor spouse should not be a trustee of a QTIP trust because doing so may be deemed a retained interest sufficient to nullify the trust. The non-grantor spouse may be named as well as the ultimate beneficiaries, but if family harmony is an issue, a neutral trustee should be considered.

If the management of the trust assets is an issue, a qualified professional trustee should be considered.

A/B and A/B/C trust arrangements

A QTIP trust is often used in conjunction with a credit shelter trust (also called a bypass trust). This is referred to as an A/B trust arrangement. Typically, the credit shelter trust is funded with property equal to the decedent's available exemption amount, and the QTIP trust is funded with the remainder. In cases where it is not desirable for the entire remainder estate to fund the QTIP trust, a third trust can be created and funded with the difference. This is called an A/B/C trust arrangement (which is why a QTIP trust is sometimes called a C trust).

Qualified Terminable Interest Property (QTIP) Trust



Suitability

A QTIP trust can be appropriate for married couples:

- Who want to defer transfer taxes until the death of the second spouse to die
- Who have children from a previous marriage, or outside the marriage, and want to ensure that those children will receive their inheritance
- Who anticipate that the spouse who survives will remarry and want to prevent the new spouse from receiving any rights to family property
- Where one spouse will need help managing the property, or has a high exposure to creditors or lawsuits

Example

John and Mary married two years ago. It's the second marriage for John--he's 70 years old and has two children from his first marriage. It's Mary's second marriage too--she's 50 and has one child, Ann, from her first marriage. Since her divorce 25 years ago, Mary has struggled financially, raising Ann alone and helping her with college expenses. John was very successful and owned several businesses over the years--he retired recently with considerable wealth. John's children, John, Jr. and Sally, are not happy about their father's marriage and their relationship with Mary is tense, to say the least. John is devoted to Mary and wants her to live the rest of her life in comfort, but also understands his children's position. The long and hard hours John spent building his wealth were made a little easier knowing his children would benefit from his legacy.

Assuming there is no prenuptial agreement or other legal arrangement, if John were to die today, Mary would be entitled to a statutory share of John's wealth. John doesn't mind that Mary would receive his wealth, but he believes this would result in a bitter dispute between Mary and his children, as well as the potential loss of some of his wealth to court costs and legal fees.

John executes a will that transfers property directly to his children in an amount that equals his available exemption, and pours over the remainder of his estate to a QTIP trust. John names Mary as the income beneficiary and he also gives her access to principal at the trustee's discretion, though he could have given Mary more or less access to principal or no access at all. John designates a neutral professional to act as trustee. John also leaves clear instructions for his executor to make the QTIP election on his estate tax return.

Advantages

Allows assets to pass transfer tax free under marital deduction even though assets ultimately pass to non spousal beneficiaries

QTIP trusts defer taxation until the death of the second spouse to die. At that point, assets remaining in the trust can be totally or partially offset by the surviving spouse's available exemption(s).

Provides income and financial security for the surviving spouse while preserving assets for descendants

The surviving spouse does not have to be given any access to principal or any powers of appointment.

Protects assets from future creditors or lawsuits, new spouses or ex-spouses

Because a QTIP trust is irrevocable, future creditors or lawsuits, and new spouses or ex-spouses of beneficiaries will be unable to reach the assets while they are in the trust.

Provides tax planning flexibility

The executor can elect to qualify all or only a portion of the QTIP trust assets for the marital deduction. This flexibility can be beneficial in some cases. For instance, if making a full election results in putting the surviving spouse's estate into a higher transfer tax bracket, the executor might make a partial election instead to reduce overall taxes on the spouses' combined estates.

Promotes family harmony

Children from a previous marriage can feel more comfortable with a new spouse if they know their inheritance is secure.

Disadvantages

Surviving spouse's access to the trust assets is limited

Although the surviving spouse must receive all income from the trust, and can be given limited access to the principal, the surviving spouse cannot be given total access to the principal or a general power of appointment.

> **Tip**: The surviving spouse can be given the power to demand the trustee convert unproductive property to productive property.

Ultimate beneficiaries must wait until surviving spouse's death

One of the requirements of a QTIP trust is that the surviving spouse must be the sole beneficiary during his or her lifetime. Heirs must wait until the death of the surviving spouse before they can enjoy any benefits from trust property.

Disclosures

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