WASHINGTON QTIP TRUSTS

Spokane Estate Planning Council

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Note: These materials were prepared for a WSBA CLE seminar presented December 5, 2014, under the title *The Brave New World of Marital Trusts*. The materials are therefore broader in scope than the title above would suggest.

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Table of Contents

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I. Introduction to the several flavors of marital trusts (including QTIP trusts) [1]

A. Marital trusts that are not tax-motivated

1. In a *Leave it to Beaver* world[2], a simple will, in which I leave everything to my wife if she survives, and everything to the kids if I'm the survivor, is sufficient. But *Leave it to Beaver* was popular 60 years ago, and with blended families, multiple marriages, concerns about creditors and the like, such "I love you wills" are frequently not sufficient.

2. Even if there are no children by prior marriages, if I leave my half of our community estate outright to my wife, i) those assets will be subject to her future creditors and ii) if she remarries or does something imprudent in old age, I cannot be assured that my half of the estate will pass to our children as I intend.

3. If we both have children by prior marriages and both sign "I love you wills", everything will eventually pass to the children of the survivor, disinheriting the children of the first to die. That is a result that is seldom intended, but it is surprising how frequently such wills are used by couples with children by prior marriages.

B. State and federal Credit Shelter Trusts and federal portability

1. By far the most common tax-motivated marital trust is a Credit Shelter Trust.[3]

2. Less needed than they were 20 years ago when estate tax exemptions were much lower, Credit Shelter Trusts avoid tax on the first death and assure that both spouses' estate tax exemptions are available to reduce or avoid estate tax. For many years the exemption was only $600,000, and many couples used Credit Shelter Trusts to collectively exempt $1.2 million of estate tax. In recent years, the exemption amount has increased fairly rapidly, so that the federal exemption in 2014 is $5,340,000

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[1] Some portions of this outline were part of the author's written materials used at the 2014 WSBA Real Property Probate & Trust midyear meeting and seminar, presented June 7, 2014.
[2] If you don't understand that reference, Wikipedia describes the TV series as "exemplifying the idealized suburban family of the mid-20th century"
[3] Also frequently referred to Exemption Equivalent Trusts and Bypass Trusts . In this author's experience the latter term leads too many clients to fear that someone (other than the taxman) is being bypassed.

($5,430,000 next year) and the Washington estate tax exemption is $2,0120,000. Both are indexed for inflation.

3. If I leave my estate (or at least as much of it as doesn't exceed the lower of the exemptions amounts) in trust for the benefit of my wife for the rest of her life, and if her access to principal is limited to a standard related to what she needs for "maintenance, education, support and health" (the so-called MESH standard; IRC §2041(b)(1)(A)), the trust will not be taxed on my death (due to use of my exemption) and will not be included in my wife's estate since she doesn't own it when she dies. She then has her own exemption to protect her estate. Collectively we have doubled the amount that is exempt from estate tax.

4. Life is a little more complicated now that Washington has an independent estate tax with an exemption which is less than half the federal exemption. There are still wills out there that leave to such a trust "the maximum amount which can pass without incurring any *federal* estate tax" [emphasis added], which in the wrong circumstances may result in substantial Washington estate tax on the first death.

5. For first deaths occurring in 2011 and later, Credit Shelter Trusts (or "CST") are not necessarily needed for *federal* estate tax purposes. The federal Tax Relief, Unemployment Reauthorization, and Job Creation Act of 2010 ("TRA 2010") introduced the concept of **portability**; that is, the estate of the first spouse to die may make any unused exemption amount available to the estate of the survivor:

> a) The first spouse's unused exemption amount, or Deceased Spouses' Unused Exemption Amount (DSUEA) may be added to the surviving spouse's exemption if the estate of the first to die makes a necessary election (IRC §2010(c)(3), (4) and (5)).
>
> b) The election must be made on an estate tax return (Form 706) filed by the estate of the first spouse to die, a return which would often not otherwise be required of that estate. Treas. Reg. §20.2010-2T(a)(7) provides that estates filing to elect portability but otherwise not required to file may file an abbreviated return without separately valuing every asset in the estate.
>
> c) In addition to the simplicity of not needing a trust, portability offers several additional advantages: i) Unlike assets in a CST, assets in the survivor's estate get a step up in basis when the survivor dies, ii) portability provides tax benefits a CST cannot where the first spouse is relatively impoverished and the surviving spouse relatively wealthy, and

iii) portability works very well for assets that do not work well with trusts (primarily IRAs and other retirement plans).

d) On the other hand, CSTs offer other advantages, especially in Washington: i) assets in a CST remain estate tax-free regardless of appreciation while assets in the surviving spouse's estate will be taxed if they outgrow the combination of the survivor's exemption and the DSUEA; ii) there is no portability of the GST tax exemption, and iii) there is no portability of the Washington estate tax.

e) The unavailability of portability for the Washington tax is particularly problematic, since Washington's is the most onerous state estate tax in the country, and wasting the Washington exemption of the first spouse to die can be very expensive.

C. <u>Federal QTIP trusts</u>

1. If there are non-tax reasons requiring the use of a marital trust, and if the estate of the first to die exceeds that spouse's estate tax exemption, the excess amount in a trust will qualify for the marital deduction (thus avoiding estate tax on the first death) only if that estate can and does make a Qualified Terminable Interest Property (QTIP) election, under IRC §2056(b)(7).

2. To qualify for a QTIP election, the marital trust must provide that the surviving spouse is entitled to all the income from the trust and that none of the trust principal may be distributed or appointed to anyone other than the surviving spouse, for the rest of his/her life. Trusts which terminate on the surviving spouse's remarriage (or otherwise terminate before the death of the surviving spouse) do not qualify for QTIP treatment or for the marital deduction.

3. IRC §2044 provides that if a surviving spouse is the beneficiary of a trust for which a QTIP election was made at the trust's inception, then the assets in that trust (often referred to as §2044 property) at the time of the survivor's death are included in the survivor's taxable estate. Thus the combination of a QTIP election and §2044 results in tax deferral (from the time of the first death to the time of the second) rather than tax avoidance.

4. QTIP trusts are also available for Washington estate tax purposes, (but with a controversial twist discussed in Section II. below). Since the Washington and federal exemptions are different, state law allows different QTIP elections to be made for state and federal purposes. RCW 83.100.047(1)(a).

D. Generation skipping trusts

1. Most fundamentally, wealth is not taxed when it passes between spouses, but it is taxed each time it passes down a generation. To deter wealthy families from avoiding tax by leaving their estates to grandchildren and more remote descendants, Congress enacted the generation skipping transfer (GST) tax, which imposes an *additional* 40% tax on transfers which skip a generation.

2. Similar to the gift/estate tax exemption, there is a GST tax exemption in the same amount ($5.34M this year). The same Credit Shelter Trust which preserves the estate exemption of the first spouse to die can also be used to preserve the first spouse's GST exemption. Couples can therefore collectively put over $10 million into a trust or trusts that last for multiple generations (limited by the rule against perpetuities), free of estate or GST tax.

3. Portability (section B.5. above) does not apply to GST taxes.

4. There is no Washington GST tax.

5. Be aware that wealthy couples may make significant lifetime gifts to children, reducing their estate tax exemptions but having no impact on their GST exemptions (assuming no similar gifts to grandchildren), resulting at death in different estate and GST tax exemptions. If a QTIP trust benefits grandchildren and is left for the surviving spouse, with the result that those trust assets are included in the survivor's taxable estate, the generation skipping transfer will be deemed made by the surviving spouse, with the result that it will consume some or all of his/her GST exemption rather than the exemption of the first to die. If that is an undesirable result, the estate of the first to die can make a "reverse QTIP election" (IRC §2652(a)(3)). The result of such an election is the trust is a QTIP trust for estate tax purposes (and thus qualifies for the marital deduction), but it is treated like a Credit Shelter Trust for GST purposes (thus not wasting any GST exemption of the first to die).

E. A multitude of marital trusts

1. Assume H & W Smith have $16M, all community property, and that they have each made $2M gifts to children. For simplicity, assume the state and federal exemptions are $2M and $5M (ie ignore inflation adjustments), so the first to die has a $2M Washington exemption (ie undiminished by gifts since no Washington gift tax), a $3M federal estate tax exemption, and a $5M GST exemption.

2. Assuming H leaves his $8M estate in trust for the benefit of W, and on W's death separate trusts are established for each child, finally distributing to grandchildren when

each child dies. To maximize tax benefits, H's marital trust for W should be divided into four trusts (or perhaps shares) as follows:

a) $2M -- state, federal and GST exempt
The Smith Family Credit Shelter Trust

b) $1M -- state QTIP, but federal and GST exempt
The Smith Family Washington QTIP Trust

c) $2M -- state and federal QTIP, GST reverse QTIP
The Smith Family GST Exempt QTIP Trust

d) $3M state and federal QTIP, no GST reverse QTIP (GST non-exempt, but no tax due until W dies)
The Smith Family GST Nonexempt QTIP Trust

F. Who is a spouse? *Windsor* and Referendum 74

1. *United States v. Windsor*, 570 U.S. 12 (June 26, 2013). The US Supreme Court ruled 5 to 4 that the definition and regulation of marriage has historically been exclusively a matter of state law and that §3 of the Defense of Marriage Act ("DOMA") violates the equal protection clause of the Constitution to the extent it prohibits the federal government from recognizing state-recognized same-sex marriages. So in the case before it, the estate of a spouse in a New York-recognized same-sex marriage was entitled to an estate tax marital deduction for property passing to the surviving spouse.

2. In Rev. Rul. 2013-17, the IRS ruled that i) terms like "spouse", "marriage", "husband" and "wife", as used anywhere in the Internal Revenue Code, include parties to a same-sex marriage recognized under state law, and ii) if state law recognized the marriage where performed, the couple is considered married regardless of whether they live in or move to a state which does not recognize same-sex marriages (adopting the so-called "state of ceremony" doctrine).

3. In 2012, state law in Washington was enacted to recognize same-sex marriages. However, sufficient signatures were gathered to delay implementation until the issue could be put to a vote of the people. That fall, voting on Referendum 74 the people affirmed the legislation by a vote of 53.7%, and same-sex marriages have been recognized in Washington ever since. The law also provides that state registered domestic partnerships in which i) the parties are the same sex and ii) neither party is 62 or older, automatically became marriages on June 30, 2014 (unless domestic partnership dissolution proceedings are pending). RCW 26.60.100.

II. Washington QTIP trusts -- *Bracken, Hambleton,* retroactivity, and federal estate tax deduction

A. Washington estate tax and DOR's WACs regarding QTIP trusts

1. As part of the 2005 new estate tax law, the Washington Legislature directed DoR to enact regulations allowing for separate QTIP elections and otherwise dealing with QTIP issues. RCW 83.100.047 (before 2013 amendments). DoR's regulations (drafted with the help of a small task force of practitioners from the WSBA's Estate & Gift Tax Committee) provided that to get a Washington marital deduction for property passing to a trust for the benefit of a surviving spouse, the estate had to make a separate Washington QTIP election. On the death of the surviving spouse, those trusts for which a Washington QTIP election had been made would be included in their taxable estates. Necessarily, then, pre-enactment trusts (those created by spouses who died before the May 17, 2005 enactment of the new state estate tax), out-of-state trusts (first spouse died elsewhere and surviving spouse moved to and died in Washington), and trusts created by gift would not be taxable because it was not possible for grantors of such trusts or their estates to make a Washington QTIP election. WAC 458-57-105(3)(q) and -115(2)(d) (before amendment in 2009). All of this was consistent with the Legislature's direction that the Washington tax was a "stand-alone" tax "independent" of the federal estate tax. RCW 83.100.040(3).

2. Several months after promulgating its WACs, DoR started ignoring them, assessing deficiencies against estates of surviving spouses who were beneficiaries of trusts for which a federal QTIP election was made but no Washington QTIP election had been made.

3. Three years later, in February 2009, DoR amended its WACs to provide that all federal QTIP trusts (i.e. §2044 property; see paragraph I.C.3. above) are included in the survivor's taxable estate unless the estate of the first to die made a separate Washington QTIP election.

4. Much litigation ensued, with the estates of Sharon Bracken and Barbara Nelson accepted on direct appeal to the Washington Supreme Court. Many other similarly situated estates sat on the sidelines awaiting the decision on appeal, some with stays expressly stipulated to by DoR.

B. The *Bracken*[4] decision

1. In October 2012 the Supreme Court ruled unanimously in favor of the estates and against DoR, holding that pre-enactment QTIP trusts are not subject to Washington estate tax in the surviving spouse's estate.

2. The six-justice majority opinion (by Division 3 Judge Laurel Siddoway sitting pro tem) held that to be Constitutional, an estate tax may be levied only on transfers (not directly on property), that no taxable transfer occurs when a surviving spouse/beneficiary dies, and that the only basis for imposing the tax in the surviving spouse's estate is the voluntary election (the QTIP election) by the estate of the first to die to avoid tax at that time and defer taxation to the second death. Messrs. Bracken and Nelson having died before the enactment of the Washington tax and their estates having therefore been unable to make Washington QTIP elections, there was no basis for including the trusts they left for their wives in the wives' Washington taxable estates.

3. The three-justice concurring opinion (by Chief Justice Madsen) held that the state can tax a "deemed" or fictitious transfer *out of* the survivor's estate only when there is a previous deemed or fictitious transfer *into* that estate, which occurs only when the estate of the first spouse to die makes a QTIP election.

4. Under either rationale, the ability of the state to tax the trust in the surviving spouse's estate is contingent upon the estate of the first to die having made a Washington QTIP election, and no Washington QTIP election can be made when the first spouse died before enactment of the Washington tax or died a resident of another state, or when the trust was the result of a gift.

C. <u>EHB 2075</u>

1. DoR lobbied hard in the Legislature that *Bracken* was wrongly decided, that it took money away from children's education and gave it to rich people, and that it afforded married couples a tax break not available to single people.[5] Lobbying efforts by the WSBA in an attempt to educate the Legislature as to what the Court really held were to no avail.

2. At the very end of the seconded extended legislative session of 2013, the Legislature passed (officially at 12:30am, June 14, 2013), and Governor Inslee immediately signed, EHB 2075 (the "Act").

3. The Act first amends the definition of the Washington taxable estate (RCW 83.100.020(14) (previously subparagraph (13)) to include all §2044 property . It then amends RCW 83.100.047 to provide that if a Washington QTIP election had been made

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[4] The official reporters refer to the case as *Clemency v. Department of Revenue*, 175 Wn.2d 549 (2012), named after the personal representative of the Bracken estate. Everyone else, including the Supreme Court justices, refer to it as Bracken, the name of one of the decedents.

[5] The reality, of course, is the opposite is true: the tax in dispute is imposed only on married people. See paragraph D.3.b).(3) below.

by the estate of the first to die, §2044 property is subtracted from the Washington taxable estate, and the property subject to the Washington QTIP election is included instead. The Legislature simply ignored the Constitutional authority Justice Siddoway cites in her majority opinion to the effect that there is no taxable transfer unless the transfer creating the trust is subject to the tax.

4. The Act further provides that it is effective "retroactively to all estates of decedents dying on or after May 17, 2005" (the effective date of the Washington estate tax), except as to taxpayers having obtained a contrary "final judgment, no longer subject to appeal." In other words, the legislation overrules *Bracken*, retroactively as to all estates other than those of Mrs. Bracken and Mrs. Nelson.

D. <u>The *Hambleton* decision and retroactive taxation</u>

1. After the *Bracken* decision was announced and prior to enactment of EHB 2075, several estates (including the estate of Helen Hambleton) obtained summary judgment against DoR, citing and relying upon the Supreme Court's decision in *Bracken*. In opposition to the motions in the trial court, DoR had been unable to say anything more than it hoped the Legislature would change the law. DoR nevertheless appealed those cases to the Courts of Appeals.

2. In one case, the estate of Jessie McBride, the trail court granted summary judgment to DoR, before the *Bracken* decision was issued. The estate moved to join the Bracken estate before the appellate courts, a motion that was denied. After *Bracken*, the McBride estate amended its briefs to argue that the decision in *Bracken* was controlling.

3. At the initiative of the Court of Appeals, and on motion filed by DoR and granted by the Court, the Hambleton and McBride cases respectively were heard by the Washington Supreme Court. In its decision issued October 2, 2014 (*Estate of Hambleton v. DoR*, 2014 WL 4925666), the Court ruled unanimously (in an opinion authored by Justice Wiggins) in favor of DoR and against the estates:

> a) On the substantive tax issue, the Court accepted the Legislature's finding that any "shifting from one to another of any power or privilege"[6] is a taxable transfer, completely sidestepping the issue of whether the decedent need have anything to do with the "shifting". In other words, it seems to have held that if there is a "transfer", the tax can be imposed on virtually anyone regardless of whether the unfortunate taxpayer is in any common sense of the word a transferor. In doing so, it ignored (and effectively overruled) the rationale in the majority opinion in *Bracken,* it

[6] Language found in *Fernandez v. Wiener*, 326 U.S. 340, 352 (1945), but applied by that Court in an entirely different context.

ignored (and again thereby overruled) its earlier opinion in *Estate of McGrath*, 191Wash. 496, 505, 71 P.2d 395 (1937) (expressly holding that a decedent has to do something more than die to be a transferor), and it took transfer taxes to a place neither Congress, the IRS, nor any other taxing authority has ever taken them.

b) With regard to retroactivity, the Court correctly cited *United States v. Carlton,* 512 U.S. 26 (1994) to the effect that there must be a legitimate purpose for retroactivity and that the period of retroactivity must be rationally related to that purpose, but it applied those rules in a context that renders those limitations almost meaningless:

(1) The purpose of the retroactivity was to "avoid a fiscal shortfall" which, according to the Court was all the "legitimate purpose" the Legislature needed. Of course any retroactive application of a change in tax law will raises additional revenue and helps avoid a fiscal shortfall.[7]

(2) With regard to the period of retroactivity, an amendment which changes a tax law retroactively back to the inception of the tax is reasonable, because to do otherwise "would allow some estates to escape the tax while similarly situated estates would be subject to it." Of course any change in tax law applied prospectively only would have that effect. In fact the opinion states that to do anything other than change the law back to the date of enactment of the tax would be "arbitrary."

(3) The Court also accepted at face value the Legislature's finding that EHB 2075 was needed avoid a tax benefit available only to married taxpayers[8], when in fact even a superficial understanding of QTIP trusts reveals the EHB 2075 imposes a tax *only* on married taxpayers. The operative provision of the Act requires the inclusion of §2044 property in the Washington estate (where no Washington QTIP election was made), §2044 brings into a surviving spouse's estate property for which a *marital* deduction was previously allowed, and such a marital deduction could only be allowed if the couple was married. *If Mrs. Hambleton had been*

[7] The Court also asserts that the rational purpose in *Carlton* was "largely economic" when in fact the *Carlton* decision simply does not refer to economic concerns. Instead it refers to what Congress "reasonably viewed as a mistake" and promptly remedied. During the three years in which DOR's original WACs were in effect, the Legislature made no effort to change the law.

[8] Section 1 of the Act states that it remedies "an inequity never intended by the legislature because unmarried individuals did not enjoy any similar opportunities to avoid or greatly reduce their potential Washington estate tax liability."

Ms. Jones, unmarried significant other to Mr. Hambleton, then EHB 2075 would not have included the trust in her estate.

(4) As of this writing, the McBride estate has filed a motion for reconsideration on a narrow procedural issue applicable only to it. The period of time within which to seek a writ of certiorari from the US Supreme Court does not run until the early part of next year.

E. <u>Who pays the tax on Washington QTIP trusts and is it deductible for federal purposes?</u>

1. Pursuant to IRC §2207A, when §2044 property is included in the surviving spouse's taxable estate, the estate is entitled to reimbursement from the QTIP trust for the additional tax attributable to such inclusion. The "additional tax" is the difference between the tax with the QTIP trust included and the tax without it included.

2. The same right to reimbursement applies to the Washington estate tax under RCW 83.110A.030 and .080 (Chapter 83.110A is the Washington Uniform Estate Tax Apportionment Act).

3. State death taxes (including estate taxes such as Washington's) are deductable for federal estate tax purposes pursuant to IRC §2058.

a) So a $5.7 Washington estate usually pays no federal estate tax ($5.34 exemption amount plus $390K deduction for Washington estate tax paid > $5.7 million estate)

b) However IRC §2058 allows a death tax deduction only as to state taxes paid "in respect of any property included in the [federal] gross estate."

c) If a Washington-only QTIP election was made on the first death, that trust will not be included in the federal gross estate, and the Washington tax attributable to the trust will not be deductable for federal purposes.

d) The IRS has provided no guidance as to what portion of the Washington tax is attributable to the Washington-only QTIP trust and therefore not deductable. Is it proportionate (ie the value of the Washington trust vs the value of the rest of the estate) or is it the difference between the Washington tax with and without inclusion of the Washington QTIP trust (similar to the amount that is reimbursable from the QTIP trust).

III. Using a QTIP election to obtain a basis step-up in marital trust assets

A. <u>The issue</u>

1. As we know, when a person dies, the basis in his/her capital assets is adjusted up or down to fair market value on the date of death. IRC §1014. Given inflation, the adjustment is more often than not up and is therefore commonly referred to as a "step-up" in basis.

2. Assets in a typical Credit Shelter Trust are not owned by the decedent, do not pass from the decedent, and therefore do not get a step-up when the surviving spouse dies. However, if the trust is a QTIP trust, step-up occurs, since under IRC §2044, assets in the trust are deemed to have passed from the beneficiary/decedent and are included in his/her taxable estate.

3. With the federal exemption at $5.34 million and the state exemption a hair over $2 million, there are many estates which would like to use a Credit Shelter Trust to take advantage of the Washington exemption of the first to die, but have no need to do so for federal estate tax purposes.

4. Given the fact that the Washington law (both before and after EHB 2075) allows different QTIP elections for state and federal purposes, can we make a federal QTIP election to get basis step-up but make no state QTIP election to take advantage of the first spouse's Washington estate tax exemption? The answer is "yes", but with a couple of important caveats (sections B. and C. below).

5. For instance, assume H & W have a $4 million community property estate, H dies and leaves his $2 million in trust for W, and his estate makes no QTIP election. His estate avoids estate tax because it is less than both exemption amounts. Similarly when W dies with a $2 million estate there is no estate tax, but the assets in the trust get no second step-up in basis at that time. However, if a federal (only) QTIP election had been made on the first death, step-up would be available but W's federal taxable estate (now $4 million due to §2044) would still be below the federal exemption and there would be no estate tax.

6. Even if the couple's combined estate exceeds the federal exemption, it may still be possible to QTIP the Washington Credit Shelter Trust without increasing the federal tax if the estate of the first to die elects portability.

B. <u>Rev. Proc. 2001-38</u>

1. In Rev. Proc. 2001-38, the Service ruled that it would disregard unnecessary QTIP elections; that is, if a QTIP election does not result in a reduction in estate tax for

the estate of the first to die (if, for instance, the marital deduction was unnecessary due to the federal exemption). By disregarding the QTIP election, the Service was saying the QTIP trust would not be included in the survivor's estate under §2044 and a disposition of the income interest by the surviving spouse would not be a gift under §2519. In its own words, the Service was providing "relief" to taxpayers (estates of surviving spouses) by protecting them from QTIP elections made inadvertently or by incompetent tax practitioners. The ruling does not cite any supporting authority for disregarding unnecessary QTIP elections.

2. Many commentators argue that taxpayer/estates should be able to comfortably ignore Rev. Proc 2001-38 and make QTIP elections which do not reduce the taxable estate, given i) arguably elective language in the ruling, ii) the principal that the IRS may be able to disregard the law when it is to taxpayers' benefit but not when it is to their detriment, iii) the fact that revenue procedures (unlike revenue rulings) are not interpretations of the law, and iv) the Rev. Proc.'s express purpose to provide taxpayer relief, and so forth. However, there is no authority on point and no more recent guidance from the IRS.

3. The ruling also states that it does not apply where a partial QTIP election was made that exceeded the amount necessary to reduce the taxable estate to zero. Practitioners still concerned about Rev. Proc. 2001-38 may want to consider making a federal QTIP election as to only 99% of the trust rather than all of it.

C. <u>The necessary Washington QTIP election</u>

1. As described above, under RCW 83.100.020(15) as amended by EHB 2075, if no Washington QTIP election is made, the surviving spouse's taxable estate includes all federal §2044 property. So under the example described above, with no Washington QTIP election made on the first death, but with a federal QTIP election having been made, the entire trust would be included in the survivor's Washington taxable estate, completely frustrating the state tax purpose of the trust.

2. The solution is to make a small, partial Washington QTIP election, sometimes referred to as a "1% Washington QTIP election".

3. Federal regulations, incorporated by the WACs, provide that partial QTIP elections are permissible, and they are very commonly made. The regulations require that partial QTIP regulations be made on a fractional basis, not a pecuniary basis.

4. In the example above, a 100% federal and 1% Washington QTIP election means that 1% of the trust is included in W's Washington taxable estate but all of the QTIP trust gets a step-up in basis.

5. It should be possible to make the election even smaller than 1%; say "the smallest possible fraction of the estate greater than zero."

6. DoR personnel were asked informally whether it might be possible to make a $0 Washington QTIP election; that is, an affirmative election that avoids the inclusion of all §2044 property in the survivor's estate, without the silliness of including 1% (or the smallest possible fraction) of the trust in the survivor's Washington estate. The informal response has been "no." Proposed WACs under EHB 2075 circulated in April 2014 do not address the issue.

IV. Disposition of surviving spouse's interest in a QTIP trust to reduce Washington estate tax

A. The issue

1. Assume H & W had a $6M community property estate and that H dies leaving $3M in trust for W. H's estate split the trust $2M/$1M and made a Washington-only QTIP election with regard to the $1M trust.

2. Late in life W's needs have become modest, and she gifts a little over $1M of her estate to the children to bring her estate below the $2M Washington exemption. However, the $1M trust for which H's estate made a Washington QTIP election will also be included in her taxable estate. RCW 83.100.047(3)(b).[9] Is there any way to avoid that result?

3. Alternatively, in a larger estate subject to federal estate tax, the surviving spouse wanting to reduce the Washington estate tax through gifting may want to make those gifts first from the Washington-only QTIP trust, since any state tax attributable to that trust will not be deductable for federal estate tax purposes (see discussion at II.E. above).

B. The IRC §2519 deemed gift with no Washington gift tax

1. Under IRC §2519, a surviving spouse's gift of some or all of his/her income interest in a QTIP trust is deemed to be a gift of the entire trust.[10]

[9] This result is now codified as a result of EHB 2075 discussed above. Previously such inclusion in the survivor's estate was required only by the WACs. Although DOR sometimes implied otherwise, none of the many estates involved in *Bracken*-related litigation challenged the inclusion of a trust in the survivor's taxable estate where a Washington QTIP election had been made with regard to that trust.

[10] Technically §2519 says that the disposition of any of the income interest in a QTIP trust is a disposition of the entire trust other than the income interest. The disposition of the income interest is governed by the usual provisions of the Code; if no consideration is received, it is a gift subject to IRC §2511.

2. There being no Washington gift tax, the disposition of the income interest triggers no Washington tax, and the surviving spouse later dies holding no interest in the trust. In the example described above, if W disposes of her interest in the $1M Washington only QTIP trust, she dies with an exempt $2M estate.

3. Some commentators have expressed the concern that if the trust's governing instrument has a spendthrift clause (i.e. a provision that prohibits a beneficiary from transferring any of his/her beneficial rights under the trust to a third party), as almost all marital trusts do, such a clause may render void any attempted disposition of the spouse's interest.

a) Such clauses are intended to prevent a beneficiary's assignment of his/her interest to a creditor or a creditor's seizure of such an interest, and arguably should be given no broader application.

b) The commentary to §58 of the Restatement (3rd) of Trusts distinguishes between a voluntary or involuntary assignment, which is validly prohibited by a spendthrift clause, and a rejection or release of a beneficial interest, which is not. The primary difference is that in the former case the income interest survives (and perhaps the beneficiary has some ability to direct to whom it passes) and in the latter case it does not (with the likely result that the trust terminates and the trust assets pass to the remainder beneficiaries, with no direction by the income beneficiary).

c) Consideration should be given to drafting QTIP spendthrift clauses so that they expressly provide that a release by the income beneficiary, with no direction as to whom (or whether) the interest may pass is not an alienation prohibited by the clause.

C. <u>Divide the trust if the beneficiary does not want to relinquish his/her entire interest</u>

1. Note that read literally (which is how the IRS reads it), §2519 provides that a gift of *a portion* of the surviving spouse's income interest is nevertheless a gift of the *entire* trust. That is a harsh trap for the unwary. Fortunately the problem is easily avoided -- if the QTIP trust is first divided into two trusts[11], and the surviving spouse relinquishes her interest in all of one of the trusts, the regulations provide that the deemed gift will be of that trust only. Treas. Reg. §25.2519-1(c)(5).

[11] RCW 11.108.025(3) gives a trustee the unilateral power to divide a single trust into multiple trusts if doing so "is of benefit to the persons interested in the trust." The same can be accomplished with a TEDRA agreement under RCW 11.96A.220, if all parties interested in the trust are parties to the agreement.

2. One might be tempted to think that relinquishing a small portion (say 10%) of the beneficiary's interest gets the entire trust out of the taxable estate, since such a relinquishment is deemed to be a gift of the entire trust.

a) However, by retaining an income interest (in this case the 90% of the original interest not relinquished), the beneficiary runs afoul of IRC §2036(a), which provides that if an interest in property is gifted and another interest (other than an undivided fractional interest) is retained for life, the value of the entire property is included in the taxable estate.[12]

b) Since the retained interest will bring the trust into the surviving spouse's federal taxable estate, DOR will certainly take the position that it will bring the trust into the state taxable estate as well, since by statute the federal taxable estate is the starting point for determining the state taxable estate.

c) Again, the problem should be avoided by first dividing the QTIP trust into two trusts and having the beneficiary relinquish his/her entire interest in one of them, retaining no part of the relinquished trust.

V. High tax rates on income and capital gains retained in trusts

A. <u>The 3.8% Medicare surtax on net investment income – IRC §1411</u>

1. To help fund the Affordable Care Act and help avoid the "fiscal cliff", the American Taxpayer Relief Act of 2012 (ATRA) imposes an additional 3.8% tax on the lesser of i) net investment income, and ii) the amount by which AGI exceeds a floor or threshold amount.

2. Net investment income includes interest, dividends, royalties and rent, as well as capital gain. Not included are income from the conduct of a trade or business (if not a passive activity in the hands of the taxpayer) and distributions from retirement plans and IRAs.

3. For individuals, the threshold amount is $200,000 for a single taxpayer and $250,000 for couples filing jointly.

[12] Normally lifetime taxable gifts are added back into the estate, the tax is calculated, and that tax is reduced by the uniform credit. However, lifetime gifts are not added back into the estate if they are included in the estate under other sections of the Code, such as §2036(a), so double taxation of the gift is avoided. The conventional wisdom— that taxable gifts are subtracted from the donor's lifetime estate/gift tax exemption-- is easier to understand and accurate for most purposes, but it is not how the unified estate and gift tax regime actually works.

4. For trusts, the threshold amount is the amount above which the trust is subject to the highest income tax rate, a mere $12,150 in 2014.

B. Higher income tax brackets under ATRA

1. ATRA also introduced a new highest income tax bracket of 39.6% (up from 35%) and a higher capital gains rate of 20% (up from 15%) for higher income taxpayers.

2. For individuals, both of these higher rates apply to the extent income exceeds $400,000 for a single taxpayer and $450,000 for a couple filing jointly ($406,750 and $457,600 respectively in 2014; indexed for inflation).

3. Again for trusts, these higher brackets begin with only $12,150 of taxable income.

C. Taxing beneficiaries instead of the trust

1. More often than not, trust beneficiaries will not be in these high tax brackets, and when trust accounting income is distributed, a trust gets a deduction and the income is taxed to the beneficiaries at their rates.

2. There is a common misconception that when trust accounting principal is distributed, the same thing occurs as to capital gain, but such is generally not the case. How to get capital gain out to the beneficiaries has been the subject of many scholarly articles and much commentary, the details of which are well beyond the scope of this presentation. The problem is well recognized, but there does not appear to be much consensus about a solution.

3. Oversimplifying a bit, a trust gets a deduction (IRC §661) and beneficiaries include in income (§662) amounts distributed to beneficiaries, but in no event more than the trust's distributable net income (DNI) (defined in §643(a)). Under the latter section, capital gains "shall be excluded [from DNI]" if they are not "paid, credited, or required to be distributed to any beneficiary during the taxable year."

4. Treasury regulations further defining DNI declare a general rule that capital gains are not included in DNI and narrowly define three exceptions to the general rule, applicable only to the extent authorized by the terms of the governing instrument or applicable law:

§ 1.643(a)-3 Capital gains and losses.

(a) In general. Except as provided in § 1.643(a)-6 and paragraph (b) of this section, gains from the sale or exchange of capital assets are ordinarily excluded from distributable net income and are not ordinarily considered as paid, credited, or required to be distributed to any beneficiary.

(b) Capital gains included in distributable net income. Gains from the sale or exchange of capital assets are included in distributable net income to the extent they are, pursuant to the terms of the governing instrument and applicable local law, or pursuant to a reasonable and impartial exercise of discretion by the fiduciary (in accordance with a power granted to the fiduciary by applicable local law or by the governing instrument if not prohibited by applicable local law)—

> (1) Allocated to income (but if income under the state statute is defined as, or consists of, a unitrust amount, a discretionary power to allocate gains to income must also be exercised consistently and the amount so allocated may not be greater than the excess of the unitrust amount over the amount of distributable net income determined without regard to this subparagraph § 1.643(a)-3(b));
>
> (2) Allocated to corpus but treated consistently by the fiduciary on the trust's books, records, and tax returns as part of a distribution to a beneficiary; or
>
> (3) Allocated to corpus but actually distributed to the beneficiary or utilized by the fiduciary in determining the amount that is distributed or required to be distributed to a beneficiary.

5. Each of the exceptions is problematic:

    a) Exception (1) (gain allocated to income) is probably limited to unitrusts and situations where the trustee exercises its power to adjust under RCW 11.104A.020 (Washington's version of the Uniform Principal and Income Act). Note that a trustee/beneficiary may not exercise the power to adjust (RCW 11.104A.020(c)(7)).

    b) Exception (2)'s consistency requirement renders it unavailable in the view of many commentators, unless from year 1 and forever after, gain has been treated on the trusts books, records and returns as included in distributions to beneficiaries.

    c) The first part of exception (3) suggests difficult tracing issues. If a distribution of principal is made in January and the sale generating capital gain occurred the following December, can it really be said that the capital gain was "actually distributed" to the beneficiary? As for the second part of exception (3), it would be a rare governing instrument that determined the amount distributable to beneficiaries by reference to the trust's capital gain.

6. Much of the commentary on this issue glosses over (or fails to mention entirely) a much more fundamental problem. If the trust has a large amount of capital gain, will distribution of that much principal to the beneficiaries (regardless of how it's taxed) defeat the non-tax purposes of the trust, which usually involve some strong element of preservation and appreciation of principal for the benefit of the remainder beneficiaries?

VI. Implications for planning and funding marital trusts

A. The new paradigm

1. The conventional wisdom has been – with estate tax rates being at 40% (or more) on the entire value of property and income tax rates being less than that (often a lot less than that) on only income and gain, it makes sense to plan to minimize estate taxes and let the income tax consequences fall where they may.

2. Now that a couple can avoid estate tax with estates under $4M and pay the confiscatory federal estate tax rates only on estates in excess of almost $11 million, the income tax consequences have become much more significant.

3. If federal political winds continue blowing as they have over the past decade, will the federal estate tax eventually disappear and replaced by even higher income tax rates? Would Washington continue to have an estate tax if there was no federal estate tax?

4. Many commentators are arguing that from a tax point of view, the most difficult estates to plan for are those (at least in Washington) between $2 million and $10 million.

B. Some things to think about

1. Consider drafting all marital trusts (i.e. Credit Shelter in addition to QTIP[13]) so that they are required to distribute all income currently.

2. Consider drafting "one lung" marital trusts; that is, a single trust for the benefit of the survivor, with the PR given broad discretion to split it, and make tax elections, in whatever manner he/she/it deems appropriate

3. Consider drafting marital trusts funded by disclaimer, especially for estates near the lower end of the range discussed above.

4. Consider drafting that requires the first spouse to die to file whatever return may be required to take advantage of portability.

5. Consider drafting spendthrift clauses (at least those applicable to QTIP trusts) which expressly do not apply to a mere relinquishment or release of the lifetime income interest.

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[13] Of course any trust for which a QTIP election may be made must require that *all* of its income be distributed.

6. Consider funding the survivor's interest (as opposed to the Credit Shelter Trust) with assets with high appreciation potential, if such appreciation will trigger little or no estate tax.

7. Consider making a federal-only QTIP election with regard to a Credit Shelter Trust needed only for Washington tax purposes, but remember to also make a minimal Washington QTIP election.

8. Consider using portability to exempt assets which do not work well in a trust, such as retirement plans.

9. Consider gifts by the surviving spouse to reduce the Washington estate tax, and where the estate is large enough to be subject to federal estate tax, consider making such gifts from the Washington-only QTIP trust.

10. Consider the non-tax purposes of a marital trust (eg assuring that the first spouse's estate eventually passes to his/her children and not the step-children) and whether any tax-wise planning would frustrate that purpose.