

## **TENNESSEE QTIP TRUSTS™**

### **ALLOW TAXABLE GIFTS WITHOUT PAYING TENNESSEE GIFT TAX**

**by Bryan Howard, Waller Lansden Dortch & Davis, PLLC**

Federal law allows each individual to give the applicable exclusion amount, currently \$675,000, to anyone without paying federal transfer tax. This amount may be used for lifetime gifts or testamentary bequests. 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 federal transfer tax base. The author frequently hears the complaint that 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 election but for which the donor elects not to make the election on the federal gift tax return. The donor does not 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. This satisfies the "all income" requirement for the marital deduction under Treas. Reg. Section 25.2523(e)-1(f)(8).

To the extent the amount of income not withdrawn at the end of the year exceeds 5% of the value of the trust assets on such date, the trust should require any such excess income to be distributed to the spouse. 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 Section 2036. To the extent that income remains in the trust, it will escape federal transfer tax. Assuming that the trust is structured as a grantor trust as to corpus (it will automatically qualify as a grantor trust as to income), the trust will be able to grow in value on a pre-tax basis.

The donor should not have a successor life estate or discretionary principal interest following the death of the donee spouse. This would cause estate tax inclusion for the donor under Code Section 2036.

When the donee spouse predeceases the donor, the donee's estate will incur Tennessee inheritance tax if the value of the trust upon the donee spouse's death exceeds the Tennessee inheritance tax exemption. 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 in the amount of the donee's applicable exclusion amount (as opposed to a traditional credit shelter trust).

When the donor spouse dies first, his or her Tennessee exclusion amount will exceed the federal exclusion. Accordingly, the donor spouse's Will

should establish a Tennessee Credit Shelter Trust. A Tennessee Credit Shelter Trust is a QTIP Trust for which a federal QTIP election is made, but for which no Tennessee QTIP election is made. Because no Tennessee QTIP election is made, the Tennessee Credit Shelter Trust will not be included in the donee spouse's estate for Tennessee inheritance tax purposes.

The following chart illustrates the tax consequences of utilizing a Tennessee QTIP Trust for a hypothetical married couple. The example is based on the following assumptions: Wife's assets \$3 million, Husband's assets \$1 million; annual pre-tax yield 8%, tax 2%, annual after-tax yield 6%; annual consumption (other than taxes) \$130,000, annual growth of consumption 3%; years until death – first-to-die 10 years, survivor 20 years; all consumption and taxes are paid out of non-trust assets to the maximum extent possible. The status quo column illustrates the results of not utilizing a Tennessee QTIP Trust and instead utilizing a traditional credit shelter trust upon the first death. The other columns illustrate the results of utilizing a Tennessee QTIP Trust with alternative orders of death.

<b>Comparison of Taxes</b>			
	Status Quo	Tennessee QTIP Trust	
		Donor Dies First	Donee Dies First
TN Inheritance Tax – Yr 10	\$ 0	\$ 0	\$ 77,207
TN Inheritance Tax – Yr 20	0	219,999	117,002
Fed and TN Estate Tax – Yr 20	2,019,224	722,578	188,426
Total Death Taxes	2,019,224	942,577	382,635
Decrease vs. Status Quo	N/A	1,076,647	1,636,588
Percentage Decrease	N/A	53%	81%

The greatest tax savings result when the donee spouse dies first because the donor's applicable exclusion amount is "put into play" for 20 years prior to the time that it would be used under traditional credit shelter trust planning. The tax savings suggest that the Tennessee QTIP Trust should be established by the spouse with the longest life expectancy. However, the donor spouse will not have access to the assets in the Tennessee QTIP Trust following the donee's death.

In summary, Tennessee QTIP Trusts will permit Tennesseans to make lifetime gifts without paying Tennessee gift tax. In order to capture the tax savings that can result from such gifts, some sacrifices will be required. Many will judge that the rewards justify these sacrifices.