

The QTIP Trust: A Powerful Planning Tool for Blended Families

Remarriages are increasingly common. According to recent data from the U.S. Bureau of Labor Statistics, by age 55, nearly 27% of those who've married have done so two or more times. As a result, "blended" families — in which one or both spouses have children from a previous marriage — are also increasingly common.

Estate planning for blended families can be challenging. You'll likely want to ensure that your current spouse is well provided for, while also preserving a portion of your estate for your children from a previous marriage. If you leave assets to your current spouse outright, however, there's nothing to prevent him or her from spending it, mismanaging it or leaving it to a new spouse, effectively disinheriting your children from your previous marriage. One strategy that can help you achieve your objectives is a qualified terminable interest property (QTIP) trust. It may also offer tax and asset protection benefits.

What's a QTIP trust?

A QTIP trust is an irrevocable trust that pays out its income to your surviving spouse at least annually and meets certain other requirements. After your spouse dies, the trust's remaining assets go to your children or other beneficiaries, but they're treated as part of your spouse's estate for tax purposes.

A carefully designed QTIP trust can help you strike a balance between competing objectives by providing your spouse with income for life while preserving the trust assets for your other beneficiaries. The assets are protected by 1) appointing a qualified trustee to ensure they're invested and managed wisely, and 2) restricting your spouse's access to the trust principal.

However, if you'd like your spouse to have limited access to principal in the event of unexpected needs or financial challenges, you may authorize the trustee to make discretionary distributions for your spouse's health, maintenance and support according to standards that you set.

What are the tax benefits?

At one time, QTIP trusts were commonly used in estate planning to defer estate taxes. That's because assets transferred to a QTIP trust are sheltered from gift and estate taxes by the unlimited marital deduction. When the beneficiary spouse dies, the trust assets are included in his or her estate, but are usually protected against tax by that spouse's gift and estate tax exemption. Ordinarily, to qualify for the marital deduction, you must transfer property to your spouse outright or through a trust in which your spouse's interest won't terminate. The QTIP trust is an exception to this rule.

Now that the federal gift and estate tax exemption has grown to an inflation-adjusted \$15 million (\$30 million for married couples filing a joint tax return), those taxes aren't a concern for most families. However, QTIP trusts also provide valuable income tax benefits. Because the trust assets are included in the beneficiary spouse's estate for tax purposes, they enjoy a stepped-up basis (to fair market value) in the hands of the remainder beneficiaries (for example, your children). That means the remainder

beneficiaries can sell the assets without triggering a hefty capital gains tax on the appreciation that occurred during the beneficiary spouse's life.

What are the asset protection benefits?

A QTIP trust also offers some protection against claims by the beneficiary spouse's creditors or a future spouse. The level of protection depends on several factors, including applicable state law and the structure of the trust.

For example, asset protection may be stronger if the trust has an independent trustee, restricts the beneficiary spouse's access to or control over the trust assets, and either prohibits distributions of principal to the spouse or limits them to discretionary distributions by the trustee to meet the spouse's health, maintenance and support needs. It may also be helpful to include a "spendthrift" clause, which prohibits use of the trust assets to pay the beneficiary's debts.

Is a QTIP trust right for you?

For blended families whose wealth is well within the exemption amount or is unlikely to reach it in the future, a QTIP trust can be a powerful tool for achieving their planning goals while providing the younger generation with valuable income tax benefits. However, these trusts may not be the best choice for reducing gift and estate taxes. If you expect your wealth to be exposed to these taxes, it may pay to consider additional tools, such as a credit shelter trust, that strikes a balance between estate and income tax benefits. Contact your estate planning advisor to help determine if a QTIP trust would be beneficial for your situation.

SIDEBAR: Accelerating your children's inheritance

One drawback of a qualified terminable interest property (QTIP) trust, especially if your current spouse is considerably younger than you, is that your children may have to wait years or decades before they receive the trust principal. If you'd like your children to receive their inheritance sooner, consider the use a life insurance policy to create immediate benefits for them while leaving other assets to your spouse. If estate taxes are a concern, consider placing the policy in an irrevocable life insurance trust (ILIT). A properly structured ILIT generally ensures that the insurance proceeds bypass your taxable estate.