

# Agricultural Law

The newsletter of the Illinois State Bar Association's Section on Agricultural Law

## Consider the single-fund QTIP trust for your farmer clients

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**Where do we start in telling our wealth-building clients about how the trusts that we draft work?** The elephant in the room is the client's fear about a second marriage subtracting from children's opportunity to wealth. The other uncertainty is taxation subtracting from children's opportunity to wealth. We look to the QTIP trust to provide flexibility in the mid-sized estate silo. The following letter provides a vehicle for presenting a draft of the single-fund QTIP trust. This letter should be changed to fit planning needs and facts.

Dear (Clients):

We have previously discussed the size and growth of your estate. We also talked about goals and objectives for distribution of your assets after your deaths. We have reviewed the scope, rates, exclusions and exemptions with respect to income, estate, generation skipping and gift taxes. You are also aware that congress could change some of the assumptions made in this letter; therefore you need to think about the flexibility of your plan.

I recommend that your trusts, on death, place all assets, excepting the marital residence, into a single-fund QTIP (Qualified Terminal Interest Property Marital Trust) to provide flexibility with respect to administration and taxation.

Your combined net worth is less than

the federal taxable amount of \$5.49 million (\$5.6 million in 2018) and you have no federal estate tax planning issues, but without planning you may someday incur Illinois estate taxes. It is also crucial that you get the income tax planning for your estate right. *You want to ensure that all assets get a "fresh-start" fair market value basis for income tax purposes upon the surviving spouse's death.* The key is to create a trust which causes inclusion of the trust assets in the survivor's gross estate. Structuring the trust to qualify for the QTIP exception will meet the requirements for a QTIP election after death if you need to plan for Illinois estate tax reduction. The non-elected portion will escape Illinois Estate taxes (currently beginning for estates in excess of \$4,000,000) by being moved to a family-type trust that will not be included in the surviving spouse's estate. The family-type trust will not qualify for a second income tax basis increase.

The QTIP-elected portion will be included in the surviving spouse's estate, thus assuring that assets of the first spouse to die will qualify for the stepped-up income tax basis under IRC §1014. (References to the Internal Revenue Code in this letter will be stated as "IRC".)

The single-fund QTIP trust strategy is designed to establish a single trust to permit QTIP (Qualified Terminal

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Interest Property under IRC §2056(b)(7) elections, to be made to take advantage of tax laws that may exist at the time of death for both Federal and Illinois estate tax returns. Adjustments that may be needed are discussed below.

### 1. General Recommendations

I recommend that the surviving spouse be given a limited power to appoint assets to descendants (normally your children). The limited power of appointment provides the safe harbors discussed in IRC §2056 and allows for post-death flexibility to adjust your estate plan. The class of possible recipients (*i.e.*, children and/or charities) permitted by your trusts can be narrowed or expanded without any negative estate tax impact. The limited power of appointment is the standard drafting found in the QTIP trust to reduce risks of a child's share being diminished by a parent's (surviving spouse) future personal decisions. These are risks presented by re-marriage, bad estate planning decisions and potential elder financial abuse changing the estate plan.

### 2. Why Choose the QTIP style Marital Trust?

Your recommended QTIP trust limits broad risks of surviving spouse control perceived with the general power of appointment and also provides tax planning flexibility. Five paragraphs of the QTIP marital trust give you the road map of how assets are used and restricted.

The spouse can have a power to provide distributions for himself or herself subject to an ascertainable standard (a power to invade principal) for necessary for the health or maintenance in reasonable comfort of the spouse (*i.e.*, not a general power of appointment).

### 3. Discussion of the Marital Trust Road Map

**The terms of the QTIP Marital Trust.** (See attached provisions from IICLE, Illinois Estate Planning Forms and Commentary) Certain of these provisions are mandatory (required by the IRC) to allow the Marital Trust to qualify for the marital deduction. Other terms are optional and should be included or omitted as your circumstances dictate. Your trusts will establish "qualified terminable interest property" (QTIP) trusts.

The five marital trust provisions of your trust are discussed as follows:

Paragraph 4.1 is a mandatory direction to distribute income. This is required by the IRC. Discretion to distribute income or termination of the right to receive income, such as upon remarriage or disability, will disqualify the trust for marital deduction purposes. Income restriction provisions must *not* be included in the Marital Trust.

Paragraph 4.2 provides for distribution of principal to the surviving spouse in the discretion of the trustee. The scope of principal distributions can be modified to fit your circumstances. The standard in your trust is a narrow or ascertainable one relating to the education, health or maintenance in reasonable comfort of the surviving spouse. An ascertainable standard is not required for marital deduction purposes but is advisable if the spouse is to act as trustee and QTIP treatment is desired.

This ascertainable principal invasion standard is deemed to be a power to consume, invade or use property for the benefit a surviving spouse limited and related to "health, education, support and maintenance" (including in reasonable comfort). Health purposes will include nursing care. Often income will not provide enough to provide for the standard of living you have been accustomed to maintaining. This definition should not be expanded without understanding how the money could be taxed for estate or income taxes. In no event can one other than the spouse be the recipient of discretionary rights to principal during the spouse's life.

Paragraph 4.3 directs that, on the death of the spouse, any Marital Trust death taxes are to be paid from the Marital Trust. A definition of "Marital Trust Death Taxes" may be added to provide that the *increase* in estate taxes in the surviving spouse's estate resulting from the property being included in the surviving spouse's gross estate will be paid from the marital trust.

Paragraph 4.4, deals with distributions at the death of the surviving spouse. The surviving spouse is allowed to appoint the Marital Trust property to any of your descendants (for example, children and grandchildren). The class of possible recipients of the power of appointment can be narrowed or broadened. Including charities

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in a limited power of appointment may save estate taxes.

The power of appointment may allow the surviving spouse to provide for the special needs of any one or more children, allows the surviving spouse to place restrictions on a spendthrift child, rewards education or charitable occupations of a child who may not be able to produce economically as another sibling, and other needs for adjustment to shares that may not be equal for the children or grandchildren.

Paragraph 4.5 disposes of any property not disposed of pursuant to the spouse's exercise of the power of appointment. The overall pattern is that the property is distributable to the children, but, depending on ages, the property will be distributed outright, held in separate trusts, or held in a single trust. The mode of distribution depends on the ages of the children. First, if any child is under the age of 25, your trust may direct that the property shall be held in a (child's separate) trust. Second, withdrawal rights to the trust property may begin at age 25. After age 30, for example, the child may withdraw all assets. The child could elect to allow the trustee to manage the property, subject to small trust termination provisions. Alternatively, the you may desire separate trusts for each child until a more mature age or a fraction of the principal may be withdrawn upon different attained ages.

#### **4. When can you decide how the trust will be allocated for tax purposes?**

A QTIP election can be made up to 15 months after the date of death and allows post death choices for amount of state and federal estate taxes paid after the death of the first spouse. It also allows for allocation of assets to anticipate future income tax and cash flow needs for the surviving spouse and the other surviving family members. Remember, if a partial QTIP election is contemplated, the goal is for the non-QTIP elected portion *not* to be included in the surviving spouse's estate.

Alternatively, a qualified disclaimer of all or any part of the marital trust may be used to allocate a specific asset, amount or a percentage of your assets in the QTIP trust to the family trust. Given the type of assets in your trust, using a disclaimer is a viable strategy for the surviving spouse to take a second look at the estate plan to avoid estate

taxes.

A qualified disclaimer with respect to any interest in property has the effect of treating that interest, for gift, estate and generation-skipping transfer tax purposes, as if it had never been transferred to the disclaimant. A disclaimer is a qualified disclaimer only if: (1) it's a written, irrevocable, and unqualified refusal to accept an interest in property; (2) the disclaimant hasn't accepted the interest or any of its benefits before making the disclaimer; (3) the interest passes, without any direction on the part of the disclaimant, to either the decedent's spouse or a person other than the disclaimant; and (4) the nine-month rule is satisfied. An interest in property, as to which a qualified disclaimer may be made, includes an undivided portion of an interest in property. The key to exercising the disclaimer is not to accept any benefits of the property disclaimed before the disclaimer is made.

#### **5. You Will Not Choose an Unrestricted Marital trust**

Marital deduction trusts (with a general power of appointment) permit a marital deduction for a gift or a bequest of an interest in property with respect to which (a) the spouse is entitled to receive all of the income from such property at least annually, (b) the spouse has the power to appoint the entire interest in favor of himself or herself or in favor of his or her estate, and (c) no person other than the spouse has the power to appoint any part of the interest to any person other than the spouse. In addition, the spouse's power of appointment must be exercisable by the spouse alone and in all events. See IRC §§2056(b)(5), 2523(e).

#### **6. Assets may not be administratively efficient for the single-fund QTIP (Marital Trust)**

Retirement assets, if any, will likely require distributions above income earned and, if in a QTIP trust, will require special drafting to reduce income tax penalties. Normally IRAs are left to the surviving spouse to provide the most flexibility in income tax deferral.

#### **7. What kind of assets should not be used to fund a QTIP trust?**

It is possible that your estates could

contain property that would not be available for the marital deduction. Often, the asset problem is cured by a power requiring the trust to make the asset productive on demand by the surviving spouse. Common examples of unproductive assets are coins, art, a residence and recreational land.

Another example of an asset not eligible for the marital deduction is an interest in the marital trust that could be terminated before the spouse dies. The variations of "terminable interests" are seen in tax cases. Alternatives are to give the terminable interests directly to the spouse, to a non-marital trust or to disclaim the asset. You do not have this type of asset in your estate.

You will create a family (separate) trust to hold assets not eligible to be held in a QTIP marital trust. Your executor and trustee have the power segregate any such marital deduction non-eligible property from the trust over which QTIP elections will be made or give those assets directly to your spouse. The family trust may also receive assets if the surviving spouse disclaims assets or if the marital trust needs to be divided for the purpose of avoiding estate taxes as discussed below. Your estate does not create other special circumstances to consider greater use of special family trusts that restrict the use of assets by the surviving spouse.

#### **8. Other tax considerations that we discussed in designing your estate plan**

Portability of Estate tax exemptions, if needed, requires filing an estate tax return for the initial estate. Portability is not recognized for Illinois estate taxes.

Less than full qualification for QTIP in the marital deduction may be accomplished by election (partial or full on Form 706) on the personal representative's part or by disclaimer by the surviving spouse. This may be used to reduce Illinois estate tax or to shift assets to reduce the size of the surviving spouse's estate. The tax return election provides the post death flexibility in taxation decisions.

#### **9. Closing Comments**

Your trusts permit partial QTIP elections to allow tax savings from Illinois estate tax and possibly federal estate tax. This election will split/allocate the trust. Depending on your circumstances and the law at time of

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death, additional flexibility for federal estate tax planning is drafted into your trusts. When family members (the surviving spouse and children) are the primary concern and a partial QTIP election is intended to avoid Illinois estate taxes, normally the power of appointment should remain narrow (such as appointing only family members). If your estate is less than \$4,000,000, (possibly subject to adjustment in the event of substantial lifetime gifts) the executor/trustee may elect to leave the assets in the marital trust.

Your plan has **income tax benefits**. There is the opportunity under IRC §1014 for a second step-up in income tax basis when the last spouse dies. How you take advantage of the step-up in basis rules will depend, in part, on your investment decisions over a period of time. Retirement accounts do not have a step-up in income tax basis.

The limited power of appointment may

allow the survivor flexibility in re-allocating estate assets to descendants or charities.

### Article 4—Marital Trust

The trustee shall administer the Marital Trust as follows:

#### 4.1 Mandatory Payment of Income.

Beginning with my death, the trustee shall pay all the income to my spouse. Despite any other provision of this instrument, on the death of my spouse any accrued or unpaid income shall be paid to my spouse's estate.

**4.2 Discretionary Payment of Principal.** The trustee may pay to my spouse as much of the principal as the trustee from time to time considers necessary for the health or maintenance in reasonable comfort of my spouse.

**4.3 Payment of Death Taxes.** On the death of my spouse, unless my spouse directs otherwise by will or revocable trust specifically referring to this instrument, the

trustee shall pay the Marital Trust death taxes.

#### 4.4 Power of Appointment at Death.

On the death of my spouse, the trustee shall distribute the principal not required for payment of the Marital Trust death taxes to any one or more of my descendants as my spouse appoints by will, specifically referring to this power of appointment.

#### 4.5 Distribution on Termination.

On the death of my spouse, the trustee shall allocate any principal not required for payment of the Marital Trust death taxes and not effectively appointed in shares of equal value for my then-living children, subject to the Child's Separate Trust withholding provisions, provided that if a child of mine is not then living but a descendant of the child is then living, the trustee shall distribute the share that would have been allocated for the deceased child, if living, per stirpes to the child's then-living descendants. ■