

CONSIDER LATE CLAYTON QTIP ELECTION – AN OLD AND COLD BYPASS TRUST CAN BE CONVERTED INTO A CLAYTON QTIP TRUST, EVEN AFTER 15 MONTHS FOLLOWING THE DECEDENT’S DEATH

Many planners are of the understanding that a QTIP election must be made for a testamentary trust on a federal estate tax return that is timely filed within 15 months following the decedent’s date of death (the general deadline of 9 months following the decedent’s date of death, plus a 6 month automatic extension). However, Treasury Regulation § 20.2056(b)-7(b)(4)(b) provides that a QTIP election is valid if it is made on “the last estate tax return filed by the executor on or before the due date of the return, including extensions or, if a timely return is not filed, the first estate tax return filed by the executor after the due date.” (emphasis added).

This allows estates where a “QTIPable” bypass trust exists to make a QTIP election well after the decedent dies, if such election is desirable for income tax planning. A QTIP election is also able to be made even where no estate tax is due as a result of the decedent’s death, and can also be made as to only a portion of the assets in a bypass trust. This type of QTIP election is known as a “Clayton QTIP election,” which is named after the Clayton Est. v. Comr. (97 T.C. 327 (1991), rev'd, 976 F.2d 1486 (5th Cir. 1992) case where such a QTIP election was permitted.

In light of the recent increases to the estate tax exclusion amount, making a Clayton QTIP election for a bypass trust can be an excellent planning technique because the bypass trust will be included in the surviving spouse’s gross estate for federal estate tax purposes in order to obtain a step-up in income tax basis on the assets held under the trust upon such spouse’s death.

A “late” Clayton QTIP election can be made by the decedent’s personal representative, as the Fifth Circuit Court of Appeals in the Clayton case found that a QTIP election relates back to the date of the decedent’s death so a late filed federal estate tax return should effectively cause a bypass trust to be considered a QTIP trust for federal tax purposes. Accordingly, all income of the Clayton QTIP must be paid to the surviving spouse, dating back to the date of the decedent’s death.

In order for this technique to apply, the bypass trust must be “QTIPable.” That is, the trust must otherwise qualify as a QTIP trust by meeting the following requirements:

- (1) The property must pass from the decedent and be included in his or her estate for federal estate tax purposes;
- (2) All income must be payable to the surviving spouse no less than frequently than annually;
- (3) The surviving spouse must be the only beneficiary of the trust during his or her lifetime; and
- (4) The surviving spouse must have the ability to compel the trustee to convert unproductive property.

This “QTIPable” requirement might cause the most trouble for many planners who wish to get a step-up in basis on the assets held under a previously established bypass trust upon the surviving spouse’s death.

One approach is to reform the bypass trust under state law to have the terms thereof comport with the QTIP trust requirements. Although, the IRS is not required to respect the orders of state law courts lower than the highest court in the state, reforming a bypass trust that does not otherwise qualify might be appropriate and could be successful if there are no other alternatives available.

In Florida (and in possibly other states), a non-judicial modification might be viable to cause the changes to the bypass trust. Florida law permits non-judicial modification of irrevocable trusts after the death of the Grantor, if the trust meets certain requirements.

Another approach for possible future situations is to provide language under the trust that would cause the bypass trust to qualify as a marital deduction trust if the decedent’s personal representative makes a Clayton QTIP election at any time.

This approach can be beneficial to clients who do not otherwise have a mechanism to cause inclusion of the assets in the bypass trust in the surviving spouse’s gross estate. We typically favor having an independent committee appointed under the bypass trust to give the surviving spouse a general power of appointment to cause the estate inclusion necessary to get a step-up in income tax basis. Nevertheless, the approach of allowing the conversion of a bypass trust to a QTIP trust upon the making of a Clayton QTIP election can be an excellent alternative, especially where the surviving spouse might have creditor concerns that would nullify the benefits of giving him or her a general power of appointment with respect to bypass trust assets.