Achieving Tax Benefits Through the *Inter Vivos* QTIP Trust

Sisi C. Tran, Esq., Director of Trust and Estate Planning

Introduction

With the passage of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, timely planning is essential as increased transfer tax exemptions are available to individuals who act within the next two years. Unfortunately, family dynamics such as second marriages often prevent a roadblock for effective planning. This paper addresses a planning technique designed to allow a taxpayer to take advantage of the increased exemptions while maintaining some control over the ultimate disposition of wealth.

Because of the unlimited gift tax marital deduction for gifts between spouses, estate planning that makes use of a lifetime or *inter vivos* Qualified Terminable Interest Property (QTIP) trust can be an effective means for passing more wealth to a married couple's children by taking advantage of both spouses' transfer tax exemptions. The inter vivos QTIP can be an even more powerful transfer technique when employed with other tax strategies such as making the trust a grantor trust for income tax purposes and paying the estate tax (or gift tax) with non-QTIP trust assets to preserve the exempt character of the QTIP property. Notably, for marriages resulting in a blended family, the donor spouse can still accomplish these objectives without sacrificing control over the ultimate disposition of the property when the donee spouse's interest ends, and the donor spouse may even retain a secondary life interest in the QTIP trust (if the donor survives the donee spouse) without risking inclusion of the QTIP assets in the donor spouse's estate.

Overview of the Marital Deduction

Under Internal Revenue Code ("IRC" or the "Code") §2056, the government grants an unlimited federal *estate tax marital deduction* for certain qualifying dispositions of property to the surviving spouse at the death of the first spouse. In addition, §2523 of the Code grants an unlimited federal *gift tax marital deduction* for qualifying transfers between spouses during life. Together, these two deductions provide a powerful estate planning tool available for married couples. Efficient use of the marital deduction incorporates the use of both spouses' applicable exclusion amounts (or unified credits) and GST tax exemptions. However, it is important to remember that the deduction is a *deferral* of the wealth transfer taxes and usually does not reduce the estate tax burden on marital assets. Where an outright gift or bequest to the spouse is not made, the key to obtaining the marital deduction is to pass the property to the survivor in a "qualifying" form — that is, a form that will cause inclusion of the assets in the recipient spouse's estate at his or her death and thus wealth transfer taxation at that time.

The most common estate planning structure for married couples uses the unified credit of the first spouse to die in conjunction with the unlimited estate tax marital deduction through non-marital and marital dispositions. The typical plan provides for a nonmarital gift to a nonmarital trust (i.e., the bypass trust or credit shelter trust) through a formula disposition referencing the first-to-die's remaining applicable exclusion amount with the residuary estate passing to the surviving spouse (in trust or outright).[1] The primary objective

[1] For smaller estates (or estates within the applicable exclusion amounts for both spouses), the alternative would be to make an optimum marital deduction formula gift to the surviving spouse (in trust or outright) and devise the residuary estate to the bypass trust. In any

of this simple format is to result in a "zero-taxable estate" upon the death of the first spouse (through deferral) while also allowing for the full use of each spouse's unified credit so that up to double the applicable exclusion amount can pass to the next generation transfer tax-free.

Prior to 1982 there were only four qualifying forms of dispositions to the surviving spouse that permitted a marital deduction: (1) outright transfers; (2) a §2056(b)(5) marital trust giving the surviving spouse a life income interest with a general power of appointment[2]; (3) life insurance settlements under §2056(b)(6); and (4) estate trusts. The one common thread with each form of disposition was that the property remaining at the surviving spouse's death (if any) would be included and taxable in his or her estate. While they continue to qualify today, dispositions of this type give the surviving spouse unfettered control over the property at death, which may be an undesirable outcome in many situations.

Terminable Interest Property and the Nondeductible Terminable Interest Rule

Generally, if an interest passing to a surviving spouse from the decedent is a *nondeductible terminable interest* then the decedent's estate will be not receive the benefit of the marital deduction for that interest. Of course, that begs the question: what is a nondeductible terminable interest?

A *terminable interest* is any interest in property that will terminate or fail either on the mere lapse of time, or on the occurrence (or nonoccurrence) of some event or contingency (e.g., death or remarriage).[3] A terminable interest is *not* deductible if (a) the interest was acquired by the decedent's personal representative at the decedent's direction,[4] or (b) upon termination of the survivor's interest (i) another interest in the same property will pass (ii) for less than full and adequate consideration (iii) from the decedent (iv) to a third person whose enjoyment or possession commences upon termination of the surviving spouse's interest.[5] This is known as the *nondeductible terminable interest rule*.

As a practical matter, the most common disposition which runs afoul of the rule is when a decedent makes a gift of a life estate in property to his or her surviving spouse with the remainder interest passing to the married couple's children at the time of the surviving spouse's death. Assume for a moment that the nondeductible terminable interest rule did not exist, resulting in a marital deduction at the decedent's death for the interest in the property left to the surviving spouse. An individual holding a life estate in property has no ownership interest in that property at death, which automatically passes to the remainder interest holder. Since the estate tax is imposed on property owned at death, the property passing to the couple's children would not be included in the surviving spouse's gross estate and, therefore, escapes estate tax yet a second time. In effect, the transfer tax could be completely bypassed by a married couple through the marital deduction at the decedent's death and through non-inclusion of the property at the surviving spouse's death, thereby resulting in the decedent having successfully passed the property to the next generation without ever having been subject to transfer taxation. This result is what the nondeductible terminable interest rule seeks to preclude.

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event, the bypass trust should not exceed the first-to-die's applicable exclusion amount if estate tax is to be avoided at the first-to-die's death.

[2] This "marital deduction power of appointment trust" is sometimes referred to as the "§2056(b)(5) trust" or just "(b)(5) trust."

[3] The determination of whether the interest is terminable is made as of the decedent's death.

[4] An example is where the decedent's will directs the personal representative to use estate funds to purchase a single life annuity for the survivor.

[5] §2056(b)(1)(A) and (B).

If Congress's intent in granting the marital deduction is to allow *deferral* — and not reduction — of estate taxes until the surviving spouse's death, dispositions of terminable interest property, such as a naked life estate to the surviving spouse, would circumvent the purpose of the unlimited marital deduction as Congress had intended. Therefore, when the marital deduction was introduced by the Revenue Act of 1948, Congress established the nondeductible terminable interest rule as the primary test for determining whether an interest passing to the surviving spouse qualifies for the deduction.

The Qualified Terminable Interest Property or "QTIP" Trust

IRC Section 2056(b)(7)

In 1981, Congress adopted §2056(b)(7) to grant a marital deduction for *qualified terminable interest property*, or "QTIP," so a disposition of the remainder interest to a third party (e.g., children) after a surviving spouse's naked life estate could qualify for the marital deduction. The advent of this was due largely in part to Congress's recognition that unfettered control by the surviving spouse over the remaining marital property could potentially leave the decedent's children vulnerable to disinheritance — such as under a circumstance where the decedent had children by a first marriage and a spouse of a subsequent marriage.

Typical dispositions under QTIP trusts today give the surviving spouse a life estate with the remainder passing to the children, but may be subject to the surviving spouse's nongeneral (or *limited*) power of appointment at death.[6] Recall that before enactment of §2056(b)(7) this QTIP disposition would have failed the nondeductible terminable interest rule because a *general* power of appointment would have been necessary to trigger inclusion of assets in the surviving spouse's estate at death. Consequently, this disposition would have resulted in a disallowance of the marital deduction at the decedent's death prior to 1981. However, §2056(b)(7) creates an exception to the rule so that a marital deduction is permitted — but at a cost. Obviously, if Congress allows a marital deduction for QTIP trust assets then such assets will be taxable at some point in time thereafter. Not surprisingly, under §2044 of the Code, the surviving spouse will be deemed to be the "transferor" of the QTIP trust for estate tax purposes so any assets remaining at his or her death will be included in his or her estate and taxed at that time. Likewise, should the surviving spouse consider releasing or assigning all or any portion of the income interest during life, the full value of the trust corpus, as well as the value of the gifted income interest, will be considered a taxable gift to him or her under Code §§2519 and 2511, respectively. Since transfer taxes will be ultimately imposed, the surviving spouse's interest no longer constitutes a nondeductible terminable interest but, instead, is now qualified terminable interest property.

QTIP Qualification Requirements

Briefly, QTIP property must meet strict requirements: (1) the property must pass from the decedent; (2) the surviving spouse must be entitled to an income interest for life; (3) no other beneficiary may have any rights in the trust during the spouse's life; and (4) an irrevocable QTIP election must be made.

[6] A limited power of appointment does not allow the surviving spouse to exercise the power to appoint any remaining assets in favor of herself or her estate.

The requirement that an election be made to be treated as QTIP is necessary because without one the disposition form of a QTIP trust in itself would not cause automatic estate or gift tax inclusion in the surviving spouse's estate.[7] It is the election which triggers the estate tax under §2044 at death or the gift tax under §2519 upon subsequent disposition of the property. However, since §2056(b)(7) does not require the surviving spouse be given a general power of appointment over QTIP trust corpus at death, the surviving spouse no longer has unfettered control over the transferred property and the decedent can "lock in" the final disposition of the QTIP assets to his or her intended remainder beneficiary(ies) without losing the marital deduction benefit.[8]

Creating a QTIP Trust during Life a/k/a the *Inter Vivos* QTIP Trust

IRC Section 2523(f)

Common estate planning for spouses of unequal wealth generally involves having the wealthy (or propertied) spouse transfer assets to the non-wealthy (or non-propertied) spouse in order to efficiently absorb both spouses' unified credits and GST exemptions.[9] While testamentary QTIP planning under §2056(b)(7) can provide an avenue for efficient use of both spouses' exemptions, it is ineffective where the non-propertied spouse passes first. If the non-propertied spouse predeceases owning no (or insufficient) property, his or her transfer tax exemptions are wasted because ownership of the property is required for it to be estate taxable. Therefore, gifting property to the non-propertied spouse during life is necessary to capture the transfer tax exemptions of both spouses regardless of who dies first.

However, prior to the introduction of the inter vivos — or lifetime — QTIP trust under §2523(f), disposition forms qualifying for the gift tax marital deduction for gifts between spouses also required that the recipient spouse be given ultimate control over property whether or not the couple remained married. The enactment of §2523(f) changed this by allowing the propertied spouse to make a tax-free gift to his or her spouse through an irrevocable QTIP trust created *during life*. Like its testamentary counterpart, an inter vivos QTIP election treats the donee spouse as the transferor of the QTIP thus subjecting the transferred property to estate tax at the donee spouse's death or to gift tax upon disposition of the property during life. Even though the donee spouse is required to receive an income interest for life, he or she no longer had to be given unfettered control over the property so that the remainder can be disposed of as the donor spouse directs (or pursuant to the donee spouse's limited power of appointment if granted).

Why an *Inter Vivos* QTIP Trust?

While almost every estate plan of a married couple contains a testamentary QTIP trust, the same does not hold true for an inter vivos QTIP trust. Establishing a QTIP during life offers several advantages and planning

[7] The election is made either by the donor spouse on a timely gift tax return or by the decedent's personal representative on a timely filed estate tax return at death. The election is irrevocable once made.
[8] Note that giving the surviving spouse a general power of appointment would automatically qualify the entire trust for the deduction as a §2056(b)(5) marital trust – meaning partial QTIP election is not available and *reverse* QTIP election planning may be lost.
[9] Since married couples in community property states generally own community assets equally, this concern is more prevalent in non-community property states.

flexibilities. The technique can create opportunities that allow the donor spouse to effectively transfer more to the next generation transfer tax-free.

Married Couple of Unequal Wealth – Utilizing the Less Wealthy Spouse's Transfer Tax Exemptions

When a married couple consists of spouses of unequal wealth, the propertied spouse should always consider gifting enough assets to the non-propertied spouse to efficiently consume both spouses' transfer tax exemptions. While this can be accomplished by making a gift outright to the non-propertied spouse, if the propertied spouse has any reservations with gifting a significantly large amount of assets to his or her spouse combined with the loss of control over the transferred property to that spouse, establishing an inter vivos QTIP trust can help alleviate any concerns. With a larger $5 million gift and estate tax exemption amount for 2010 through 2012, any hesitations may very well be warranted. Since §2523(f) treats the donee spouse as the transferor, the property will be taxable at the donee spouse's death (or sooner if otherwise disposed of) thus absorbing his or her exemption. Thus, the inter vivos QTIP trust enables a married couple to take advantage of the non-propertied spouse's unified credit, GST exemption, as well as a full bracket run in his or her estate — all without the propertied spouse having to give up the ability to finally dispose of the property.

Given the inclusion of the portability provisions in the "2010 Act," does the use of an inter vivos QTIP trust make sense? [10] Yes, for several reasons. First, the 2010 Act's estate tax provisions will expire on December 31, 2012, meaning under current law unless a spouse dies in 2011 or 2012, portability will not be available. Second, even where portability is available, only the "last deceased" spouse's exemption can be used. In other words, if Wife in the example remarries and Husband #2 also predeceases her, Wife must use Husband #2's unused exemption (since he is the last deceased spouse) — she can no longer use Husband #1's exemption. Under this scenario, Husband #1's exemption would be completely wasted. Further, even with the option of portability, it would still be more tax advantaged for a married couple to use a "bypass trust" in their estate plan at the first spouse's death as opposed to portability.[11] This is because funding the bypass trust on the first to die's death allows all appreciation within the bypass trust to avoid the estate tax at the surviving spouse's death. Similarly, an inter vivos QTIP also provides for estate tax-free appreciation between the donee spouse's death and the donor spouse's death. Finally, portability does not apply to a deceased spouse's GST exemption whereas the inter vivos QTIP trust (as well as a testamentary bypass trust) will absorb the non-propertied spouse's GST exemption at death. In sum, portability does not eliminate the viability of the inter vivos QTIP technique.

In any event, due to the continuing uncertainty in the transfer tax laws beyond 2012, the QTIP trust provisions should include formula language which adjusts for future changes in the estate tax exemption amount. Whether Congress ultimately adopts permanently an exemption amount of $1 million, $3.5 million, or $5 million — or even permanently repeals the estate tax — the inter vivos QTIP trust can be written to take into account all scenarios so both spouses' exemptions are fully used without gifting to the non-propertied spouse more than necessary. Basically, the trust can provide that any trust property in excess of the donee spouse's maximum estate tax exemption amount (at death) will be distributed outright back to the original

[10] Under the 2010 Act, portability is available to the surviving spouse for decedents dying after 2010. Portability allows a surviving spouse to use his or her deceased spouse's unused unified credit. For example, assume Husband dies in 2011 not having used any exemption during life. If elected, Wife can use all of Husband's unused $5 million exemption plus her own $5 million exemption to exclude assets from the gift and estate tax during life or at death. Note that portability does not apply to a deceased spouse's unused GST exemption.

[11] The bypass trust is also known as a "credit shelter trust" and is generally funded with the first spouse to die's remaining unused applicable exclusion amount.

donor spouse. This effectively uses only the portion of the QTIP trust assets that can be sheltered by the donee spouse's exemption.

Leverage Donor Spouse's GST Exemption

Also under the 2010 Act, beginning in 2011 the gift and estate tax exemption is reunified so that each individual can exclude up to $5 million of assets during life or at death. The GST exemption is increased to $5 million as well. This means (for tax years 2011 and 2012 under current law) a donor having all of his or her gift tax and GST tax exemptions available can use all of his or her GST exemption amount during life without also having to pay a gift tax.[12] Nevertheless, many donors have already used $1 million of his or her gift tax exemption without also using the GST exemption thus resulting in a donor's GST exemption amount exceeding his or her remaining gift tax exemption. Under this circumstance, a donor will not be able to use all of his or her GST exemption during life without also having to pay a gift tax. For example, assume Husband has used $1 million of his lifetime gift tax exemption as of 2010, has made no other gifts and has never used any of his GST exemption. In 2011, Husband has as additional $4 million of gift tax exemption remaining and all $5 million of his GST exemption. If he wishes to use all $5 million of his GST exemption during life, $1 million will be subject to gift tax. If such a disparity arises between a donor's remaining gift and GST exemption amounts, those seeking to leverage the compounding effect of the additional GST exemption during life can still do so through the inter vivos QTIP.

In the example, Husband can establish an inter vivos QTIP trust and make a *reverse* QTIP election under §2652(c) so that Husband will be treated as the transferor for GST tax purposes thus causing his GST exemption to be allocated to the trust assets. This technique effectively allows the donor to fully use his or her GST exemption on a gift tax-free basis for any incremental increase of GST exemption over the gift tax exemption.[13]

Structure as Grantor Trust to Pass More to Remainder Beneficiaries

Notwithstanding the requirement that all income be paid to the beneficiary donee spouse, trust corpus can be preserved by making the inter vivos QTIP trust a *grantor trust* for income tax purposes. A fundamental concept of tax planning is that property exempt from tax should ideally be maintained in that tax favored environment so the value of the tax exempt property will grow.

As a grantor trust, the donor spouse will be obligated to pay the income taxes on trust income. Even for married couples where each spouse has significant wealth of his and her own, this technique can pass more to the couple's children for a less aggregate transfer tax cost. The use of the grantor trust provisions allows the exempt estate property to grow undiminished each year by income taxes. Ideally, the couple would have an abundant amount of other non-QTIP trust assets with which to pay the trust's income tax. The benefit is an *indirect tax-free gift* (with each income tax payment) to the inter vivos QTIP because trust assets, which

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[12] In prior years like in 2009, the gift tax exemption remained at $1 million while the GST exemption increased to $3.5 million. A donor who wanted to use all of his GST exemption during life would be subject to the gift tax after the first $1 million gift.

[13] Under the "all or nothing" rule, a reverse QTIP election (if made) must be made to the entire QTIP elected trust (or to the entire QTIP elected portion of a trust) – meaning, while a partial QTIP election can be made, a *partial reverse* QTIP election cannot. For example, assume the executor makes a partial QTIP election for 50% of the QTIP trust so that 50% of the trust is QTIP elected and the remaining 50% is nonelected QTIP. If a reverse QTIP election is made, it must be made to the entire 50% QTIP elected portion of the trust. The result is that the donor is the transferor as to 100% of the trust for GST tax purposes because (a) the reverse QTIP election causes the donor to be the transferor for GST tax purposes as to the 50% QTIP elected portion (while the donee spouse is the transferor for gift and estate tax purposes) and (b) the donor would remain the transferor as to the 50% nonelected QTIP portion for all transfer tax purposes since QTIP treatment was not elected as to that portion and the non-terminable interest rule would apply causing the interest to fail.

would have been distributed to pay the income tax on trust earnings, can remain inside the trust for the children and grandchildren as remainder beneficiaries.

In addition, such payments by the donor spouse will effectively reduce his or her gross estate. In this scenario, the spouse expected to live longer can create and fund the inter vivos QTIP to extend the grantor trust consequence and tax benefits to descendants. What's more, if a reverse QTIP election was made and the trust is GST exempt from inception, the donor spouse's GST exemption will not be wasted since GST exempt trust assets will not have to be used to pay the income tax on trust earnings.[14] In effect, compounding the tax-free benefits through grantor trust status effectively leaves more in the trust for the remainder beneficiaries.

Pay Estate Taxes with Non-QTIP Trust Assets to Preserve Exempt Assets

An additional strategy designed to preserve tax exempt corpus in the inter vivos QTIP is to provide for non-QTIP trust assets to be used to pay the estate taxes at the donee spouse's death (or at the donor spouse's death, whereas subsequent QTIP election is made for a donor spouse's secondary interest). For example, if a reverse QTIP election was made and the trust is GST exempt, the donor spouse's GST exemption will not be wasted since GST exempt trust assets will not have to be used to pay the estate tax. More importantly, payment of the estate tax with non-QTIP trust assets will not constitute a gift to the trust for GST tax purposes.[15]

Other Thoughts

Donor Spouse Can be Given Secondary Life Estate in Donee Spouse's QTIP

Interestingly, the inter vivos QTIP regulations allows the original donor spouse to be given a secondary life estate interest in the QTIP trust without risking inclusion of the assets in the donor spouse's estate at death (in the event the donee spouse predeceases).[16] For example, assume that an inter vivos QTIP trust was created by Husband for the benefit of Wife and that Wife predeceases Husband. The QTIP trust could provide that Husband is a beneficiary of the QTIP (which essentially becomes a *non-marital* trust) at Wife's death without the assets being included in Husband's estate at his subsequent death under §§2036 or 2038. Since QTIP trust assets will be estate taxable at Wife's death under §2044, her estate may make a QTIP election under §2056(b)(7) for the continuing trust for Husband's benefit and receive a marital deduction — the effect of which is to defer the tax to Husband's death. Obviously, if Wife has unused unified credit remaining at death then no QTIP election would be made for Husband's interest so that Wife's estate will shelter the tax. In either event, there is still no risk of inclusion of the assets in Husband's estate. This flexibility not only gives the married couple an opportunity to fully utilize both spouses' tax attributes regardless of who dies first but also (1) gives them the ability to defer the estate tax liability (through a second QTIP election), (2) allows the original donor spouse enjoyment of the property in the event the donee spouse predeceases, and (3) secures the final disposition of the property in accordance to the original donor spouse's intent.

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[14] Note that under IRC §677(a), if the grantor's spouse is an income beneficiary the trust is a grantor trust during the spouse's lifetime; however, since the spouse is only entitled to income, the grantor trust status may only be with respect to income and not corpus. Therefore, it is better to include a specific grantor trust power to ensure the entire trust is a grantor trust.

[15] Treas. Reg. §26.2652-1(a)(3).

[16] The rationale is that §2044 inclusion to the donee effectively cleanses the trust in the same manner as §2041, meaning the donor's retained secondary life estate will not cause inclusion under §§2036 or 2038, regardless of the order of deaths. See Treas. Reg. §25.2523(f)-(1), Example 11.

Ability to Manage Mandatory Income Distributions to Preserve Trust Principal

One obvious disadvantage to the inter vivos QTIP trust is the requirement that trust income be distributed to the beneficiary spouse during life. If a reverse QTIP election was made so that the trust is GST exempt, the effect of the all income requirement is a leakage of asset value compounding in the GST exempt QTIP trust. However, this can be mitigated by having the trust invest primarily in assets that do not substantially produce income. Unless the beneficiary spouse is in need of income, investing in growth assets will allow the QTIP trust to grow more quickly, transferring greater wealth to the remainder beneficiaries. Note that even though the beneficiary spouse must be able to force the trustee to make the trust assets income productive, there is no requirement that the trust produce a minimal amount of income.[17]

Divorce

While not often (if ever) thought of in the context of a divorce, the inter vivos QTIP planning may be beneficial in a negotiated divorce settlement. Here, the donor spouse would provide for the donee spouse for life as required under a divorce decree. Of course, income would be payable to the donee (soon to be ex-spouse) during life, but should the donee spouse die first, the remaining QTIP trust principal could revert back to the donor spouse who wants enjoyment of the property again and is willing to incur the estate tax for it.

Alternatively, if the donor wishes to avoid the estate tax, he or she can retain a secondary life estate (as previously discussed) without risk of estate inclusion at death. Finally, even if the donor predeceases the donee, the donor can direct devolution of the QTIP remainder at the donee spouse's death. More importantly for a divorce, the income tax liability following the divorce will cause the donee spouse to be liable for income taxes on trust income. Hence, there is no income tax disincentive in the divorce settlement use of the inter vivos QTIP trust.

Conclusion

The use of lifetime QTIP strategy offers a variety of tax advantages for married couples, including tax-free gifting between spouses; for a married couple of unequal wealth, the ability to take advantage of both spouses' transfer tax exemptions regardless of who dies first; leverage for a donor spouse seeking to fully use the GST exemption during life without having to pay a current gift tax where the donor's GST exemption far exceeds his gift exemption; the option of estate tax deferral through a subsequent QTIP election for the donor spouse's secondary life estate interest; indirect tax-free gifting through income tax payments by the donor under the grantor trust rules effectively leaving more to the remainder beneficiaries; and preservation of GST exempt QTIP assets by payment of the estate tax with non-QTIP assets — all without the donor spouse having to give up control over ultimate disposition of the transferred property. Even with the new estate tax laws enacted under the 2010 Act, the inter vivos QTIP remains a powerful technique and in certain circumstances may even be the best option (when compared to outright gifting to a spouse) given the significantly higher unified credit available.

[17] See Treas. Reg. 20.2056(b)-5(f)(4).

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