CREDIT SHELTER TRUSTS

The Role of Credit Shelter Trusts Under the New Estate Tax Law

Credit shelter trusts can be a valuable part of many estate plans despite an increased exemption amount, and practitioners should explain to clients the possible trust provisions and alternatives.

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In light of the new estate tax law enacted as part of the 12/17/2010 Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act (TRUIRJCA), new priorities and techniques must be considered to enhance conventional credit shelter trust planning. The following example is designed to review the most important aspects of credit shelter trust and QTIP trust planning under the new law, and to provide the reader with the opportunity to review these rules from the client's point of view.

Hypothetical situation

Assume that Paul is an estate tax planner, and John and Grace have been Paul's estate planning clients for over 20 years. John and Grace are educated professionals in their early 60s, with a net worth of approximately $18 million.

They have two children and four grandchildren, and have historically been involved in conventional estate tax planning structures, including revocable trusts with credit shelter trust/QTIP trust provisions, a family limited partnership, an irrevocable generation-skipping trust for their grandchildren, and an irrevocable life insurance trust (ILIT) that holds a second-to-die policy on their lives.

In addition to their $18 million in personal assets, they have each used their former $1 million gift tax exemption amounts to fund a dynasty trust for their descendants that is now worth $5 million.

John and Grace understand that under the new estate tax law, they each have an additional $4 million of lifetime gift tax exemption and continue to retain their $26,000 combined per donee annual gift tax exclusion. [1] However, John and Grace also realize that the federal estate tax is not as great a threat as it once was, because of the $5 million per person estate tax exclusion [2] and the reduced 35% estate tax bracket. [3] Like many other clients, they are hoping that the estate tax will simply disappear.

Advice sought

Although they are considering use of their new $4 million per spouse additional exemptions, today John and Grace are coming in to Paul's office to specifically discuss the best use of the credit shelter trust mechanism under their revocable living trusts. They have read an article about estate tax exclusion portability, which may reduce the need for credit shelter trust planning, and they want to know how their planning should be structured in light of the new law.

Based on their reading John and Grace specifically want to know the following:

(1) Whether they will need a credit shelter trust established on the first of their deaths in view of the portability rules, because the surviving spouse could use the remaining portion of the first dying spouse's estate tax exclusion, at least as these rules are written for 2011 and 2012.
(2) If they fund a credit shelter trust on the first death, and the estate tax later goes away, whether establishing and maintaining the trust will be worth the time and expense if no estate tax savings result from having it.
(3) Whether their estate plan can be structured so that on the first death, all assets are left to a marital trust that benefits the surviving spouse, and such assets can receive a stepped-up income tax basis on the second death. In that case, there may be little or no capital gains tax when their children and other heirs subsequently sell the assets. If capital gains tax rates come back to the Reagan-era rate of 28%, the amount their descendants someday inherit could be significantly affected.
(4) Whether they should shift the ownership of assets now, so that each of them could fund a $4 million credit shelter trust on their respective deaths. They have always situated their assets so that a credit shelter trust could be fully funded on the first death. They have held most of their assets jointly under the family limited partnership for creditor protection and right of survivorship planning, but have placed part ownership of partnership interests and other assets, including individual life insurance, separate from joint with right of survivorship or tenancy by the entireties so that a credit shelter trust could be funded on the first death.

Guidance given

Paul is familiar with the general rules concerning the funding, drafting, and structuring of credit shelter trusts, the new estate tax law changes, the possible impact of portability, the interplay between estate tax planning and income tax planning, and associated concepts. Therefore, Paul can offer the wealth transfer enhancement techniques described below to give John and Grace confidence that their credit shelter trust plan will be flexible, effective, and not unnecessarily complicated.

First, Paul explains that the purpose of the credit shelter trust is to make use of the first dying spouse's estate tax exclusion allowance, whereby assets can be held in trust for the health, education, maintenance and support of the surviving spouse and descendants. The surviving spouse can be “in charge” under the arrangement by serving as lead trustee of the trust, and have the power to choose and replace the other trustee from a list of names or any eligible trust company.

Paul also lets John and Grace know that under Section 2041 , the surviving spouse can be the sole trustee, as long as his or her ability to receive trust assets will be based on an ascertainable standard that allows for distributions to the spouse for the spouse's reasonable health, education, maintenance, and support; in that case the credit shelter trust assets will not be included in the surviving spouse's estate. If Paul's state follows the Uniform Trust Code, he can also explain that the credit shelter trust assets will be exempt from future creditors of the surviving spouse.

Power of appointment. Paul can also remind John and Grace that the documents now provide the surviving spouse with the power to designate how the trust assets pass on the second death, so that the spouse can change the direction of assets among their common descendants (and possibly charities), as circumstances change in the future. It may be helpful to explain to John and Grace that the technical term for this power is a “power of appointment” because of the frequency of usage and importance of this term later in the conversation. Moreover, if the credit shelter trust in John and Grace's estate planning documents did not already included a power of appointment, Paul would add one.

John is afraid that Grace might be inappropriately influenced by their common children to exercise her power of appointment after his death in a way that is not fair. Paul points out that the regulations under Section 2041 provide that if a trust beneficiary has the power to appoint trust assets to himself or herself, but only with the approval of a person who does not have a substantial interest in the trust (a "nonadverse party"), then the power of appointment is considered a general power of appointment.

For example, if the surviving spouse has the power to appoint trust assets to creditors of her estate, but exercise of the power is conditioned on approval by unrelated third parties, such as an independent committee of advisors, the spouse is considered to have a general power of appointment, causing the assets to be included in his or her estate and a step-up in basis at death, regardless of whether (1) the spouse attempted to exercise the power of appointment, or (2) the unrelated third parties approved any such exercise. This regulation has been very helpful for lawyers who want to draft documents to cause inclusion of assets in a person's estate in order to avoid generation-skipping transfer (GST) tax from occurring when the person dies, [4] or in order to cause a step up in income tax basis of appreciated assets, which could be a paramount tax planning objective if the estate tax is eliminated in the future.

The granting of a power of appointment by an independent committee that is subject to approval of that committee, however, might be subject to challenge by the IRS. The grounds for challenge could be that the power of appointment is illusory if it is installed in a limited or last-minute fashion. The people given the power to bestow the power of appointment should not be eligible recipients of the power or permissible beneficiaries under the trust. Otherwise they might be considered to hold the power themselves. Also, power of appointment rules could change in the future, so some degree of flexibility will be appropriate.

Planning tip

The individuals or trust company afforded the authority to give the surviving spouse a power of appointment could consist of a committee composed of the lawyer and CPA for the client, with alternates being a lawyer from the same law firm and a CPA from the same CPA firm, if this appears to work well. Trust companies are not accustomed to performing these types of services, so appointing a committee of professionals with a hierarchy of successorship that can be expected to provide professional judgment for the lifetime of the surviving spouse is appropriate.

A backup alternative would be to authorize the local probate court to appoint two board-certified independent lawyers to have such power, if and when a family member would petition the court under circumstances where no one that would be selected as a power of appointment committee member would be able to serve. Of course, an individual or entity with a substantial economic interest in the trust should not be permitted to serve on the committee or to grant the power of appointment.

Income distribution. Paul may explain that some estate planners recommend that the credit shelter trust be required to pay all income to the surviving spouse, and that the surviving spouse have the right to withdraw the greater of $5,000 or 5% of trust assets (a "5/5 withdrawal power"). Paul may also explain that a mandatory income right or a 5/5 withdrawal power can be disadvantageous because the creditors of the surviving spouse would be able to reach the income that has to be paid to the spouse each year, as well as the assets that may be withdrawn from the trust by the spouse. Additionally, mandatory payments of income will increase the surviving spouse's estate, and on such spouse's death, 5% of the trust assets may be subject to federal estate tax if she has a 5/5 withdrawal power. If the documents provide a mandatory income right or a 5/5 withdrawal power, Paul may now recommend that these be deleted from the document.

Selection of trustee. The trusteeship of the credit shelter trust is always an important topic. Clients do not want to think that a large trust company that may be insensitive to their needs might control their family's wealth, without input, based on stories that they have heard. While Section 2041 will generally permit the surviving spouse to be the sole trustee of the credit shelter trust, state law may permit creditors to invade a trust where a debtor is the sole trustee, with the ability to withdraw assets as needed for the debtor's health, education, maintenance, and support.

Based on this, as well as the advantage of having a “checks and balances system in place, the authors recommend structuring trusts held for surviving spouses so that the surviving spouse serves as a co-trustee with a corporate or professional trustee. This type of trusteeship ensures that:

- Investments are handled properly.
- Significant monies are not loaned to family members who can never repay the loans.
- Tax returns, accountings, and the costs associated with trust administration are handled efficiently.

Based on Paul's recommendation of the above, John and Grace have decided that the surviving spouse will serve as co-trustee with the spouse's choice of a licensed trust company that manages at least $500 million worth of assets, their longtime CPA, their longtime lawyer, or their best friend who is a successful professional with an MBA degree. The surviving spouse can choose one or more individuals as co-trustees, and later replace them with someone else on the list or an alternate licensed trust company. This will keep the trust assets at arm's-length from their children, and the present and future spouses of their children, and protect such assets from the potential for unwise decisions made by the children, as well as creditor claims.

Other credit shelter trust provisions. John and Grace see the importance of passing up to an additional $4 million worth of assets into a credit shelter trust upon the first death in order to protect the surviving spouse and their descendants from potential family and friends' creditors and future spouses of the surviving spouse. They know that Paul will use a formula clause to assure that the amount set aside into the credit shelter trust matches whatever their allowances are at the given time.

If John and Grace have separate children from prior marriages, the credit shelter trust will be even more important, because it can be drafted to preserve specific inheritance rights for the children of the first dying spouse, with the power of appointment held by the surviving spouse being limited or eliminated altogether. Further, distribution rights and powers can be adapted so that the children of the first dying spouse would have a better chance at receiving an eventual inheritance on the second death.

New law, new strategies

Now that Paul has covered the major considerations of a credit shelter trust, the issues and potential changes in strategy and structuring brought about by the new estate tax law can be explained and considered.

These generally consist of the following:

(1) Whether to use the new $5 million portability allowance of the first dying spouse [5] so that the surviving spouse can then leave $10 million estate tax free on the second death (less the portion of the lifetime gift exclusion that was used by John and Grace). Will a credit shelter trust be worthwhile when the portability allowance generally permits the same result as the credit shelter trust is intended to achieve? Paul should also consider the income tax ramifications of deciding to fund a credit shelter trust on the first death versus deciding to have the portability of the estate tax exclusion apply.
(2) Whether to let the surviving spouse determine whether to have a credit shelter trust or rely on portability. Paul may want to explain to John and Grace the possibility of the surviving spouse executing a disclaimer to fund the credit shelter trust with assets that would otherwise be left outright to the spouse or to a marital trust for the benefit of the spouse.
(3) If the surviving spouse decides to go with portability, whether there is a way to protect the assets that would have otherwise passed into the credit shelter trust from future creditors, divorce claims, and family and friends' creditors.
(4) Whether to amend John's and Grace's revocable trusts to provide that all assets would pass to the surviving spouse (either outright, or in a marital trust for the spouse's benefit), but to the extent that the surviving spouse disclaims, the disclaimed assets would pass into a separate trust with terms parallel to the credit shelter trust.

Use of disclaimers. Paul also explains that under Section 2518 and state law, the devise or disposition can be disclaimed in whole or in part by the person who would receive it, and the trust document can provide that in the event of a disclaimer, the assets disclaimed would pass to the credit shelter trust.

Paul must also explain, however, the disadvantages of using disclaimers in post-mortem planning. The first is that the surviving spouse cannot direct how the disclaimed assets will pass, which means that the spouse cannot retain a power of appointment over the assets disclaimed. Instead, those assets would have to pass strictly by the terms of the credit shelter trust. This concern may be ameliorated by appointing an independent committee of trust protectors or an independent trustee who would have the power to change how the assets would pass after Grace's death, if those individuals and their collective judgment are trusted.

If the disclaimer is to the same credit shelter trust that receives other assets by means not involving the disclaimer, then under Reg. 25.2518-2(e) , the disclaimant can retain a power of appointment over only the portion of the trust assets that passed to the trust through means other than the disclaimer. The disclaimant must still renounce the disclaimer over the percentage of assets corresponding to the portion resulting from the disclaimer.

To avoid running afoul of this special disclaimer consideration, Paul can recommend redrafting the credit shelter trust provisions so that if the credit shelter trust is partially funded by disclaimer, it would divide into two separate credit shelter trusts, which would be identical but for the surviving spouse not having a power of appointment over the credit shelter trust that is funded by disclaimer (a “disclaimer credit shelter trust”).

The second disadvantage of a disclaimer mechanism is that a disclaimer may not be possible under state law if the surviving spouse is insolvent. One method of ameliorating this concern would be to draft the relevant documents to provide that no outright disposition to the surviving spouse would be allowed if the surviving spouse were insolvent at the time of the contemplated distribution. In such event, the provision of the trust would instead provide for the funding of the credit shelter trust, without the surviving spouse having the power to make a disclaimer.

Another disadvantage of the disclaimer is that surviving spouses often do not make the right decisions when facing the whirlwind of the loss of their spouse and the input of various advisors (both professional and otherwise) who get involved in decision-making. The authors therefore prefer the other flexible methods described below in lieu of the disclaimer to credit shelter trust alternative. Nevertheless, when clients feel strongly that they do not want a credit shelter trust, it is very simple to draft the disclaimer language, and the language that will allow the division of the credit shelter trust into one normal credit shelter which provides the surviving spouse with a power of appointment over trust assets, and a second credit shelter trust without the power of appointment to segregate the disclaimed and non-disclaimed credit shelter assets, as described above.

The tax law specifically permits a surviving spouse to make a qualified disclaimer of assets into a trust that provides benefits for the health, education, maintenance, and support of a child or other individual. Paul explains to John and Grace, however, that if a nonspouse beneficiary makes a disclaimer of assets into a trust that provides similar benefits for a nonspouse beneficiary disclaimant, the trust assets are subject to federal estate tax in the disclaimant's estate. This may cause significant adverse tax consequences.

For example, if John and Grace want to leave an outright devise to their child, Ann, with the power for Ann to disclaim into a trust that would provide her with benefits for her health, education, maintenance, and support, they should consider leaving the assets to Ann in trust and giving her the power to withdraw trust assets based on an ascertainable standard instead. Otherwise, under present estate tax law, Ann will be considered a contributor to such trust, and the trust will be subject to federal estate tax on Ann's death unless she also disclaims the right to receive any benefits from the trust whatsoever.

Use of QTIP trust. Alternatively, a *Clayton* QTIP [6] could be formed on the death of the first dying spouse. Suppose John is expected to die first, and wishes to accomplish these aims:

- Have at least $4 million worth of assets pass into a trust that will benefit Grace and allow the future use of his remaining estate tax exclusion.
- Preserve assets for his children from a prior marriage.

A relevant question is whether the family is better off having the credit shelter trust funded to preserve his remaining $4 million exclusion, or whether it would be better for some or all of this amount to be held under a marital deduction QTIP trust, whereby $4 million would be used in whole or in part to increase Grace's exclusion under the new portability rules.

For example, on John's death, $4 million worth of assets could pass to a QTIP marital deduction trust, and then Grace would have a $9 million exclusion allowance if John's personal representative appropriately elects to have the exclusion portability apply on the estate tax return with respect to John's estate. Grace might hold on to John's remaining estate tax exclusion until she dies, or she might use any portion of such exclusion for lifetime gift giving. [7]

John would like to help assure that his children from the prior marriage receive at least a minimal portion of the family inheritance after Grace has been well-provided for during her entire lifetime. The *Clayton* QTIP may be an excellent fit for this situation. Paul explains that it would be possible to establish a trust on John's death that would qualify for the federal estate tax marital deduction, and then be considered as owned by Grace at the time of her death for federal estate tax purposes. The trust will pay its share of the estate tax incurred upon Grace's death, with remaining assets passing pursuant to the terms of the trust. Grace might be given a power of appointment over only a portion of the trust assets that correspond to what their common children (or Grace's separate children from a prior marriage, if any) would receive on her subsequent death under the terms of the trust.

Paul also explains that under the *Clayton* QTIP regulations promulgated under Section 2056(b)(7) , a trust funded on John's death can permit the initial trustee to determine whether the trust will be a QTIP marital deduction trust, a credit shelter trust, or part credit shelter trust and part QTIP trust. In order for a QTIP trust to qualify for the estate tax marital deduction, the trust must pay all income to the surviving spouse, and cannot be used for any individual other than the surviving spouse during her lifetime. John would prefer that the assets be usable for descendants in the event of an emergency, and therefore understands the advantages of having flexibility to decide whether the trust system left on the first death would involve $4 million or less in credit shelter trust funding, based on the circumstances existing at that time.

After John's death, an independent trustee can confer with Grace and the family's financial and tax advisors to determine how much of the $4 million allowance to use in the funding of a credit shelter trust, with the remainder to pass to a QTIP trust. Technically, this is done by providing a normal credit shelter trust/marital trust formula clause, but Paul can add language to John's and Grace's revocable trusts to provide that the independent trustee has the power to cause the credit shelter trust, or a portion thereof, to be a QTIP trust, with the terms of such trust to be modified so that the QTIP trust requirements under Section 2056(b)(7) are satisfied.

Paul can explain that he will draft the trust language to facilitate effective use of John's remaining GST exemption by assuring that any portion thereof not allocated to the credit shelter trust would instead be applied to the QTIP trust portion. That way, after Grace's death, the QTIP trust assets would divide into separate trusts for each child that would provide benefits for the health, education, maintenance, and support of the child, without being subject to estate tax at the child's level. [8]

For example, if on John's death, provisions were made for a $3 million credit shelter trust, a $2 million GST QTIP trust, and the remainder of John's assets funding a separate QTIP trust, then the credit shelter trust and the first QTIP trust would pass into GST trusts for the children on Grace's subsequent death, and the second QTIP trust would not be GST exempt.

Use of remaining estate tax exclusion. John and Grace ask about the consequences of increasing Grace's estate tax exclusion by John's remaining $1 million allowance if there is a $3 million credit

shelter trust funded on the first death. Whether exclusion portability occurs in whole or in part on the first death, the exclusion addition received by the surviving spouse has to be segregated and separately considered because it is inferior to the spouse's own exclusion for three primary reasons:

(1) The portable exclusion received by the surviving spouse does not grow with inflation in the same manner that such spouse's own $4 million exclusion will under the present law. While the surviving spouse's own estate tax exclusion will increase based on increases in the CPI, if the first dying spouse uses his or her entire exclusion to fund a credit shelter trust, the trust assets would have a much better chance of keeping up with or beating inflation if properly invested, according to experts. [9] For example, in the past 15 years up through 12/31/2010, the CPI increased by an average of approximately 6.72% annually, while over the same time period, the S&P 500 increased by an average of approximately 13% per year.
(2) The portability feature in the new estate and gift tax law does not allow for the portability of GST exemption. In the example above, the first dying spouse would have had to leave the first QTIP in order to not lose such spouse's GST exemption that remains at death.
(3) If Grace remarries and the new spouse dies before her with less exclusion remaining than John left, her portability exclusion will be reduced to the exclusion of the more recently deceased spouse.

If Grace would be willing to make a lifetime gift of $4 million of assets after John's death (thus immediately using his portability exclusion), then the concerns of inflation and the loss of exclusion due to a second marriage would not be problematic. Typically, however, a surviving spouse is not confident enough, or sufficiently advised, to make a $4 million gift shortly after the death of the spouse who has made most of the financial decisions.

Conclusion

The design of the credit shelter trust is more important for many clients in view of the $5 million exclusion, and many aspects need to be considered in drafting the trust. These include drafting trust provisions to provide for flexibility and to account for changing circumstances.

The new estate and gift tax law increases the importance for planners considering the income tax implications of trust documents, and how to structure trusts to allow clients to avoid income taxes as well as estate taxes to the extent possible. Further, the new estate tax law creates additional opportunities for clients and their advisors to transfer wealth with minimal tax costs, and additional choices for clients to consider how to structure the ownership and management of assets after the death of the first dying spouse. Planners must effectively and clearly communicate the various alternatives and the ramifications of their implementation to clients in order to make best use of the planning opportunities created under the new tax law.

1

Section 2503(b) ; Rev. Proc. 2010-40 , 2010-46 IRB 663.

2

Section 2010(c)(3) .

3

Section 2001(c) .

4

When a trust is established to benefit a child of the grantor and the child dies, the trust may be subject to federal GST tax unless it is “GST exempt” or includable in the child's estate for estate tax purposes. Often, the child is given a power to appoint trust assets to creditors of his or her estate, but if there is a concern that the child might exercise the power unwisely, the approval of a nonadverse party can be required.

5

Section 2010(c)(2)(B) .

6

The term is derived from Estate of Clayton, 70 AFTR 2d 92-6262 , 976 F2d 1486 , 92-2 USTC ¶60121 (CA-5, 1992).

7

The new Section 2010 does not directly address whether the surviving spouse may use the deceased spouse's remaining exclusion to make lifetime gifts free of gift tax. However, the Joint Committee on Taxation Report of 2010 specifically provides that a surviving spouse may use his or her deceased spouse's exclusion "for lifetime gifts or for transfers at death."

8

As a result of this, the second QTIP trust would be called the non-GST QTIP and, unless Grace otherwise appoints, it could pay outright to the children on her death, or alternatively pass into separate trusts for each child, where the child would, at minimum, have the power to appoint trust assets to creditors of his or her estate in order to avoid having a GST tax occur on the child's subsequent death.

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Some experts believe that the CPI is not an accurate indicator of real inflation because of the methodology used to calculate the CPI, and that real inflation may be significantly higher than indicated by the CPI. For further reading on this topic, see Kapur, “The CPI is Broken. Here's Why” (12/10/2010), http://www.fool.com/investing/general/2010/12/10/heres-why-the-cpi-is-broken.aspx.
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