Raj Patel, CPA, LLC
Raj Patel, CPA ACA M COM DTP LLB
1585 Oak Tree Road, Suite 203
Kumar Soni Plaza
Iselin, NJ 08830
(732) 283-9090
Fax: (732) 283-9091
raj@rpatelcpa.com
www.RajPatelCPA.com

Credit Shelter Trust

May 20, 2011

Credit Shelter Trust

Summary:

Prior to the enactment of the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 (the 2010 Tax Act), a married couple generally needed to implement a credit shelter trust and, in non-community property states, divide their assets evenly between them, so that they could fully use both spouse's estate tax applicable exclusion amount (also referred to as an exemption).

The 2010 Tax Act provides for portability of a deceased spouse's unused applicable exclusion amount. For deaths occurring in 2011 and 2012, a surviving spouse may add their deceased spouse's unused applicable exclusion amount to the surviving spouse's estate tax applicable exclusion amount without the use of the traditional credit shelter trust.

However, a credit shelter trust is still an important estate planning tool for many tax and nontax reasons:

- Portability may be lost if the surviving spouse remarries and is later widowed again
- The trust can protect any appreciation of assets from estate tax at the second spouse's death
- The trust can provide protection of assets from the reach of the surviving spouse's creditors
- Portability does not apply to the generation-skipping transfer (GST) tax, so the trust may be needed to fully leverage the GST exemptions of both spouses
- Portability will expire in 2013 unless Congress enacts further legislation

What is a credit shelter trust?

A credit shelter trust (also called a B trust, family trust, or bypass trust) is an irrevocable trust typically used by a married couple to minimize federal estate taxes on their combined estates.

How does a credit shelter trust work?

Prior to 2011, individuals could only use the estate tax exemption that was allotted to him or her, and any unused exemption would be lost. A married couple could fully use their respective exemptions by splitting a spouse's estate into a marital portion and credit shelter portion (this type of planning is often referred to as A/B trust planning). Here's how it works:

A credit shelter trust is funded with assets sufficient to fully utilize the exemption of the first spouse to die. The trust can be funded during the spouses' lifetimes or at the death of the first spouse to die.

The surviving spouse is given restricted access to and control over the assets in the trust. If the surviving spouse is given unrestricted access to and control over the assets in the trust, the assets would be included in his or her estate when he or she dies (which would have negated the sheltering purpose of the trust). The surviving spouse can receive:

- All annual income earned by the trust
- The annual, but non-cumulative right to withdraw the greater of $5,000 or 5% of the trust principal, for any reason
- The right to invade the trust principal if necessary for his or her health, education, support, and maintenance (referred to as the "ascertainable standards")

The surviving spouse can also be given a power to appoint all or any of the assets in the trust to a limited class of beneficiaries excluding himself or herself, his or her creditors, his or her estate, or the creditors of his or her estate (this is called a "special" or "limited power of appointment"). The surviving spouse can appoint the assets in the trust to the specified beneficiaries in any proportion that he or she desires. This allows the surviving spouse to appoint the assets to the beneficiaries who need the assets the most.

Caution: *Bypass trusts can be funded using a formula or a disclaimer. If a disclaimer is used, the trust document should not include a special power of appointment provision.*

The surviving spouse can also serve as trustee.

Tip: *In some cases, it may be better to have other family members or a professional (e.g., a bank) serve as trustee, either alone or with the surviving spouse. A neutral trustee is especially appropriate in second marriages.*

When the surviving spouse dies, the remaining assets in the trust pass estate tax free to the beneficiaries as named by the first spouse to die in the trust document, or as appointed by the surviving spouse.

Tip: *If the trust will continue after the surviving spouse dies, the trust document may need to name a successor trustee, and the trust terms must comply with the rule against perpetuities.*

Tip: *An experienced attorney should draft the trust document because if it is not precisely drafted the trust may be deemed invalid.*

Caution: *Different rules apply to non-U.S. citizens.*

The 2010 Tax Act allows the executor of a deceased spouse's estate to transfer any unused estate tax exemption to the surviving spouse without the use of a credit shelter trust. The executor of the first deceased spouse's estate must file an estate tax return on a timely basis and make an election to permit the surviving spouse to use the deceased spouse's unused exemption.

Suitable clients

- Spouses with combined assets that exceed the estate tax exemption, which is $5 million in 2011 and 2012 ($10 million for a married couple), but is set to revert to $1 million ($2 million for a married couple) in 2013.

Note: The $5 million amount in 2012 will be indexed for inflation.

Example

John and Mary are a married couple who own $10 million in assets. Assume the basic exclusion amount is $5 million and the top estate tax rate is 35%. Both the basic exclusion amount and the estate assets are assumed to grow 7% annually and Mary is assumed to die 10 years after John.

If John dies leaving everything to Mary, there will be no federal estate taxes due because, generally, the law allows an unlimited amount of property to pass to a spouse free of estate taxes. John's estate elects to pass his unused $5 million exclusion to Mary. Mary can live off the earnings of the entire $10 million estate. When Mary dies, her entire estate will pass to their children. When Mary dies 10 years later, Mary's estate will have grown to $19,671,514 and her basic applicable exclusion will have grown to $9,835,757. Mary's applicable exclusion equals $14,835,757 ($9,835,757 + John's unused $5,000,000 exclusion). The excess of Mary's estate over Mary's applicable exclusion is subject to taxes. That means that $1,692,215 would have gone to the IRS and $17,978,999 would have gone to John and Mary's children (assuming no other variables). Taxes would consume 8.6% of their combined estates.

Now, let's say that John executed a will leaving an amount equal to his available exemption to a credit shelter trust, and the rest of his estate to Mary. Say John's gross estate was $6 million. $5 million passed to the trust tax free under John's exemption, and $1 million passed directly to Mary tax free under the unlimited marital deduction. Mary can live off the earnings of her $5 million estate ($4 million plus $1 million), and can also access the income earned by the trust, as well as the principal of the trust to the extent she needs it for her health, education, maintenance, and support.

If Mary died 10 years later, Mary's estate will have grown to $9,835,757 and her basic applicable exclusion will have grown to $9,835,757; the assets in the trust, which have also grown to $9,835,757, would not have been included in her gross estate. John and Mary's children would have received the entire corpus of the trust. Of Mary's $9,835,757 million estate, all of it would have passed to their children tax free under Mary's exemption, and nothing would have passed subject to tax. That results in $0 that would have gone to the IRS and $9,835,757 that would have gone to John and Mary's children. When their estates are combined, the children would have received $19,671,514. Taxes would consume 0% of the combined estates. By using a credit shelter trust, John and Mary's children would have received an additional $1,692,515 of their parents' estates that the IRS would have received had the trust not been used.

Tip: *If John didn't want the property to go outright to Mary, John could leave the residuary estate to a marital trust instead, naming Mary as the primary beneficiary. When a credit shelter trust is used in conjunction with a marital trust, the arrangement is usually called an A/B trust arrangement.*

Calculations

Without Credit Shelter Trust	
Mary's Taxable Estate	$19,671,514
Tentative Federal Estate Tax	$6,865,830
- Unified Credit	$5,173,315
Federal Estate Tax	$1,692,515
Mary's Estate	$19,671,514
- Federal Estate Tax	$1,692,515
Mary's Net Estate	$17,978,999
+ John's Net Estate	$0
Combined Net Estate	$17,978,999

With Credit Shelter Trust	
Mary's Taxable Estate	$9,835,757
Tentative Federal Estate Tax	$3,423,315
- Unified Credit	$3,423,315
Federal Estate Tax	$0
Mary's Estate	$9,835,757
- Federal Estate Tax	$0
Mary's Net Estate	$9,835,757
+ John's Net Estate	$9,835,757
Combined Net Estate	$19,671,514

Net Estates	
With Credit Shelter Trust	$19,671,514
Without Credit Shelter Trust	$17,978,999
Difference	$1,692,515

Advantages

Achieves tax goal while giving surviving spouse maximum access to and control over trust assets

With this type of trust, if the children of the marriage are minors or have special needs, or if the surviving spouse were to otherwise need the money, he or she would be able to access the property that passes to the trust under the deceased spouse's exemption (although access would be limited, see Disadvantages).

Preserves assets for descendants

Because assets that fund the credit shelter trust bypass the surviving spouse's estate, they are preserved for the ultimate intended beneficiaries. This can be especially attractive when there are children from a previous marriage.

Protects assets from future creditor claims

Because a bypass trust is irrevocable, future creditors of the beneficiaries (the surviving spouse or the children) will be unable to reach the assets while they are in the trust. So, this strategy also works well if the children are adults and the parents don't want them to own property outright for some reason. If this is the case, a spendthrift provision should be included in the trust agreement.

Disadvantages

Surviving spouse's access to the credit shelter trust must be restricted

The deceased spouse can give the surviving spouse access to all, a portion, or none of the income from the credit shelter trust. If access to principal is allowed, it must be limited to health, education, maintenance, or support only. Health, education, maintenance, and support, or "HEMS", are four magic words used by the IRS, and there's some guidance about what they mean, but the surviving spouse will have to be careful when withdrawing principal to make sure the money's use will fall within these parameters.

Adds complexity to the surviving spouse's life

If the surviving spouse is trustee, he or she will have to maintain separate records for the trust, and ensure that he or she does not overstep the trustee's powers. If a neutral trustee is used, the surviving spouse will have to cooperate with the trustee.

Impact of portability

For the estates of persons dying in 2011 or 2012, the executor may transfer any unused estate tax exemption to the surviving spouse. While this portability has some appeal, it also has issues:

- In the case of multiple marriages, only the most recent deceased spouse's unused exemption may be used by the surviving spouse.
- Although the estate tax exemption is portable, the GST exemption is not. Couples seeking to create trusts for the benefit of their children and more remote descendants cannot take advantage of portability because the first spouse's GST exemption cannot be transferred to the second spouse.
- Any unused exemption is not indexed for inflation. As a result, if the assets transferred to the surviving spouse appreciate, the appreciation will be subject to estate taxation at the surviving spouse's death.
- Assets passing directly to an individual are subject to the claims of creditors, as explained above (see Advantages).
- The executor must make an election on a timely filed estate tax return. Such an election, once made, is irrevocable.
- Portability is set to expire in 2013, unless Congress enacts further legislation.

Disclosure Information -- Important -- Please Review