

# **The Supercharged Credit Shelter Trust<sup>SM</sup> Super Idea for Married Couples**

## **Is Now on WTP**

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Many married individuals adopt an estate plan designed to avoid estate tax upon the death of the first spouse to die while taking maximum advantage of the so-called "estate tax exemption." The plan typically involves setting apart the amount sheltered by the unified credit separately, and providing that only the portion of the estate in excess of the credit shelter amount will pass in a manner that qualifies for the marital deduction. Frequently, the credit shelter amount is set apart in trust (called the "credit shelter," "estate tax exemption," "bypass" or "family" trust) so that the surviving spouse may benefit from the property if needed without causing those assets to be included in the surviving spouse's estate for estate tax purposes. A credit shelter trust provides an opportunity to take advantage of the unified credit of the first spouse to die: unlike assets that avoid estate tax when the first spouse dies by using the marital deduction, assets (together with their appreciation) that are protected from tax by reason of the exemption of that spouse pass upon the surviving spouse's death free of estate tax and potentially also free of generation-skipping transfer tax. This article will explore making the credit shelter trust "supercharged" by structuring so it can grow free of income tax. As explained in more detail below, this occurs by making the credit shelter trust a grantor trust of the surviving spouse so all of the trust's income will be taxed to that spouse without causing the trust to be included in his or her estate. The effect of that supercharging is illustrated in the chart displayed at the end of this article. And WTP through its Lifetime QTIP Trust form offers this option, which may be implemented by clicking on only a few keys when building a lifetime QTIP trust through a new "profile."

### **Credit Shelter Trusts**

Many a well-informed spouse first to die directs for an amount of his or her estate equal to his or her unused Federal estate tax exemption to be placed into a credit shelter trust for the benefit of his or her spouse and descendants. As long as the surviving spouse does not have a general power of appointment described in Code sec. 2041, the credit shelter trust is not included in the gross estate for Federal estate tax purposes of the surviving spouse.

Sometimes, the credit shelter trust will direct that all income be paid to the surviving spouse. Although that may provide both economic as well as "psychological" comfort to that spouse, it almost certainly is not the most economically efficient structure for the entire family. It often is preferable to let the trustee decide whether to accumulate the trust's income or pay it to the spouse or one of more of the descendants. That helps avoid gift tax and provides opportunities to tax the trust's income to the taxpayer (be it the trust, the spouse or one or more descendants) in the lowest tax bracket.

In addition, where the surviving spouse has wealth of his or her own or the balance of the estate of the first spouse to die has passed either directly to the surviving spouse or a marital deduction trust, it may be preferable from an overall estate planning perspective for the spouse to expend his or her own assets (or those in the marital deduction trust) rather than receive distributions from the credit shelter trust. That way, the marital deduction property (which otherwise would be taxed as part of the estate of the surviving spouse) can "vanish" and the credit shelter trust (which should not be taxed as part of the survivor's estate) can build. Of course, to do that, the trustee should be authorized to pay principal from the marital deduction trust(s) to the surviving spouse and to accumulate the credit shelter trust and/or be authorized to make distributions from the credit shelter trust to descendants. Where it is anticipated that the credit shelter and marital deduction trusts will be so administered, it may be appropriate to provide specific authorization to the trustees and, in fact, encourage them to do that. WTP offers such language which will appear by checking the box for the Will/Rev Trust question "CHECK to encourage payments to Spouse from Marital Trust over Family Trust" on the Family Trust dialog screen—and checking that box will cause the article entitled "Estate Tax Efficient Shares" to appear in the document. Checking that box will provide that specific authorization.

### **Supercharging the Credit Shelter Trust**

Even better than accumulating the income of the credit shelter trust would be creating the opportunity to accumulate that income free of income tax. Suppose the income from the credit shelter trust could be made taxable to the surviving spouse even if the survivor does not receive that income. That way, the value of the trust could compound income tax free potentially producing a much larger fund that would pass to the couple's descendants when the surviving spouse dies without any estate tax, and potentially also without generation-skipping transfer tax. The IRS has ruled that a grantor of a trust who pays the income tax on trust income that is attributed to the grantor under the grantor trust rules of Code Sec. 671-679 does not make a gift even though the trust receives such income tax free. Rev. Rul. 2004-64, 2004-2 C.B. 7.

However, as a general rule, the surviving spouse is not the grantor of the credit shelter trust that his or her spouse created at death. Accordingly, the survivor cannot pay the income tax on the trust's income without making a gift. The surviving spouse could be made the grantor (actually, the "owner" under the grantor trust rules) under Code Sec. 678 by being granted the unilateral right to demand the entire principal of that trust. But such a power to withdraw almost certainly will cause the surviving spouse either to have made a gift and/or to cause the trust to be included in the survivor's gross estate. See Code Sec. 2041.

Nevertheless, through some careful planning before the first spouse dies, it seems that the credit shelter trust could be made to be a grantor trust with respect to the surviving spouse and without causing that spouse to be treated as making a taxable gift and without causing the trust to be included in the survivor's gross estate for Federal estate tax purposes. The potential benefits of making the credit shelter trust supercharged are illustrated in the chart at the end of this article. Also note that the increase in value of the credit shelter trust by making it supercharged not only enhances the amount passing estate tax free when the surviving spouse

dies but also enhances the amount potentially protected from generation-skipping transfer tax assuming GST exemption was allocated to the trust.

### **Lifetime QTIP Trust for the Spouse Dying First**

Suppose the wife creates a lifetime QTIP trust for her husband with sufficient assets to use his entire estate tax exemption when he dies. She elects on her U.S. Gift Tax Return (Form 709) for that trust to qualify for the gift tax marital deduction under Code Sec. 2523(f). (Note that it will not qualify for the marital deduction if the spouse for whom the QTIP is created is not a U.S. citizen. See Code Sec. 2523(i).) Thus, no gift tax is payable when the trust is created, but the entire trust will be included in the gross estate of the husband (that is, the spouse who is the beneficiary of the lifetime QTIP trust) when he dies under section 2044 of the Code. That lifetime QTIP trust is a wholly grantor trust with respect to the spouse who created it (the wife in our example) assuming her husband is a beneficiary of both trust income and principal. See Code Sec. 676, 677. Therefore, all of the taxable income of the lifetime QTIP trust (including taxable income allocated to principal such as capital gains) is attributed to the wife who will have to pay the income tax on that income.

Suppose also that the lifetime QTIP, either by the exercise of a special (non-estate taxable) power of appointment by the husband or by the provisions of the trust, passes, upon the husband's death if the wife survives, into a standard credit shelter trust using the husband's estate tax exemption. That trust would provide, in all likelihood, that the trustee could accumulate all income or pay it (and principal) to the wife or the couple's descendants as the trustee determines. Regardless of whether the trustee accumulates income or pays it to one or more beneficiaries, the taxable income will continue to be attributed to the wife under the grantor trust rules by reason of the wife's discretionary interest in trust income and principal. Even though the lifetime QTIP trust has been included in the estate of the spouse who was the beneficiary of the trust for life (the husband in our example), the spouse who created it (the wife in our example) remains the grantor for Federal income tax purposes. See Reg. §1.671-2(e)(5) (no change in identity of the grantor unless someone exercises a general power of appointment over the trust).

Even though the surviving spouse is and remains the grantor for income tax purposes of the lifetime QTIP turned in a credit shelter trust, and even though the surviving spouse is a discretionary beneficiary of the credit shelter trust, that credit shelter trust should not be included in the gross estate of the surviving spouse (unless he or she holds a general power of appointment over that trust). Although usually a grantor must include in his or her gross estate any trust he or she created during lifetime if the grantor has retained the right to income (which need not be a legally enforceable right) or has control over the beneficial enjoyment of the trust assets (such as by holding a special power of appointment over the trust property), those rules do not apply to the grantor of a lifetime QTIP trust. See Reg. § 25.2523(f)-1(f), Example 11. However, an issue does arise if the grantor's creditors, under applicable state law, can reach the assets of the trust estate to cause the trust to be included in the grantor's gross estate, as discussed below.

### **More on the Creditors' Rights Doctrine**

Under the law of most, but not all, states, a grantor's creditors may attach assets in a trust the grantor has created and from which he or she is entitled or eligible in the discretion of a trustee to receive distributions. See, e.g., New York EPTL 7-3.1; Restatement (3d) Trusts, sections 57-60.

Because the surviving spouse (who is the grantor of the lifetime QTIP) will be a beneficiary of the credit shelter trust that will be formed from the lifetime QTIP trust he or she created when his or her spouse dies, it is at least arguable that, under prevailing state law, creditors of the surviving spouse can attach assets in the credit shelter trust. Under relatively well developed law, that, in turn, could cause the trust to be included in the estate of the surviving spouse under Code Sec. 2036. See, e.g., Outwin v. Commissioner, 76 T.C. 153 (1981), acq., 1981-2 C.B. 1.

But Example 11 of Reg. § 25.2523(f)-1(f) forecloses the application of both Code Sec. 2036 and 2038 of the Code to cause a lifetime QTIP trust to be included in the gross estate of the spouse who created the trust. However, the Example does not foreclose the application of section 2041 relating to general powers of appointment. Hence, it seems that, if the spouse who created the lifetime QTIP trust is deemed to have a general power of appointment over the succeeding credit shelter trust, credit shelter trust could be included in the creator's gross estate for Federal estate tax purposes. Therefore, if the right of the grantor's creditors to attach assets in the credit shelter trust constitutes a general power of appointment, then the trust would be included in the gross estate of the surviving spouse. That means that no estate tax benefit from the creation of that trust would have been obtained—in other words, the unified credit of the spouse dying first would have been wasted.

There are, it seems, at least two ways to avoid having the spouse who created the lifetime QTIP, and becomes a beneficiary of the succeeding credit shelter trust, treated as though he or she holds a general power of appointment by reason of his or her creditors being able to attach assets in the credit shelter trust. The first likely applies in all states. It seems that in all states creditors' access to trust property, even in a self-settled trust, is limited to the maximum extent of the trustee's power to make payments to the grantor. See, e.g. comment f to Restatement (3d) Trusts, section 60. For example, if the trustee may make distributions only for the grantor's health, education, maintenance and support, then the creditors of the grantor may attach the trust assets only to the extent the trustee properly could make payments to the grantor for such purposes. Code Sec. 2041 excludes from the definition of a general power of appointment a right to property under an ascertainable standard relating to health, education, maintenance and support. Hence, if distributions by the trustee of the credit shelter trust to the surviving spouse (who was the grantor of the lifetime QTIP trust from which the credit shelter trust was formed when the first spouse died) were limited by an ascertainable standard, the grantor's creditors would be limited to distributions under that standard and, therefore, even if the grantor is deemed to have a power over the trust by reason of the right of his or her creditors to access the trust assets, that power will not be a general power of appointment causing estate tax inclusion.

The second way is to create the lifetime QTIP trust under the laws of a state that do not permit the grantor's creditors to attach the assets. That may be done under the laws of Alaska, Delaware, Nevada, Rhode Island, South Dakota, Utah and, to a limited extent, in Oklahoma.

See, e.g., Estate of German v. United States, 7 Ct. Cl. 641 (1985) (no estate tax inclusion in estate of grantor who was eligible to receive income and corpus from the trust because her creditors could not attach the trust property under the law under which the trust was created); Rev. Rul. 2004-64, *supra*.

Therefore, it is recommended that any Supercharged Credit Shelter Trust<sup>SM</sup> be formed under the law of a state (such as Alaska or Delaware) under which the grantor's creditors cannot attach the assets of that trust (even though the grantor-spouse may ultimately become eligible to receive distributions) and/or the trustee be permitted to make distributions to that spouse only on an ascertainable standard described in Code Sec. 2041 relating to health, maintenance, support and education. That way, the credit shelter trust should not be included in the estate of the surviving spouse and yet can be supercharged because it will be a grantor trust for income tax purposes with respect to that spouse.

### **Reciprocal Lifetime QTIP Trusts**

It is not always certain which spouse will die first. Also, a spouse might be hesitant to create a trust for his or her spouse because of the risk of at least a partial loss of that wealth in the event of divorce. For example, the spouse for whom the trust is created may have descendants of a different union and may divert distributions made to the spouse from the trust to them. In addition, the divorced spouse will continue to receive at least the income of the trust for life, which income will no longer be shared with the spouse who created the trust. If each spouse has sufficient independent wealth to create a lifetime QTIP trust for the other of equal amounts, then a Supercharged Credit Shelter Trust<sup>SM</sup> may be created regardless of which spouse dies first and neither spouse will have given up wealth to the other spouse because a reciprocal trust has been created by the other spouse.

Of course, that raises the question of whether the "reciprocal trust doctrine" applies. Under that doctrine, a trust created by another for a beneficiary is treated for Federal estate tax purposes as though it was created by the beneficiary where the beneficiary has created a similar trust for the person who created the trust for the beneficiary. The reciprocal trust doctrine causes the trusts to be "uncrossed" which has been used by the courts to cause estate tax inclusion where it otherwise would not apply. See, generally, G. Slade, "The Evolution of the Reciprocal Trust Doctrine Since *Grace* and Its Current Application in Estate Planning," 17 Tax Mgmt Est. Gifts & Tr. JI (1992).

For several reasons, the reciprocal trust doctrine should not apply for gift, estate or income tax purposes to the Credit Shelter Trust that is formed from one of the lifetime QTIP trusts when the first spouse dies. See, e.g., discussion in R. Covey, *Practical Drafting* (October 1993) at 3402.

### **But Don't Risk the Reciprocal Trust Doctrine**

Although it seems very reasonable to conclude that the reciprocal trust doctrine should not apply to the lifetime QTIP trusts for estate tax, gift tax or income tax purposes, it probably is prudent simply to avoid the possibility of the application of the doctrine. Case law suggests

that, if the trusts have sufficiently different terms and are created as adequately different times, the doctrine does not apply. See Levy v. Commissioner, TC Memo 1983-453.

Hence, it is recommended that the lifetime QTIP trusts that spouses would create for each other to effect a Supercharged Credit Shelter Trust<sup>SM</sup> when the first of them dies should be created at different times, be funded with different assets, have different standards for payments for the spouse for whom it was created and grant different control and have different trustee. When you build such lifetime QTIP trusts using WTP you will be given opportunities to build in such differences in terms. In any case, the Levy case suggests that if only one spouse would hold a presently exercisable special power of appointment over the credit shelter trust that will formed when the first spouse dies that is sufficient to block the application of the reciprocal trust doctrine. WTP offers this and other ways to make the two lifetime QTIP trusts and each successor credit shelter trust "different."

### Summary and Conclusions

A credit shelter trust often is created by a married person to efficiently use his or her unified credit while allowing the surviving spouse to benefit from the value of the estate tax exemption of the first spouse to die. Structuring the credit shelter trust so it is a grantor trust with respect to the surviving spouse may enhance the benefit of the trust. It turns it into a Supercharged Credit Shelter Trust<sup>SM</sup>. It is available under the WTP Lifetime QTIP Trust module and has a "profile" for the Supercharged version.

#### Chart Illustration of Supercharged Credit Shelter Trust<sup>SM</sup>

##### Amount in Credit Shelter Trust at Death of Surviving Spouse

Assumptions: \$2 million initial funding; 8% annual return; 25% effective income tax on undistributed income

<u>Years Between Deaths of Spouses</u>	<u>Amount in Trust (in Millions)</u>		
	<u>Payment to Spouse Each Year @ 4%</u>	<u>No Payment to Spouse (Spouse Not Taxed)</u>	<u>No Payment to Spouse (Spouse Pays Income Tax)</u>
5	\$2.32	\$2.68	\$2.94
10	\$2.69	\$3.58	\$4.32
15	\$3.12	\$4.79	\$6.34
20	\$3.61	\$6.41	\$9.32
25	\$4.19	\$8.58	\$13.70