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Your Married Clients Need Another Trust: A Supercharged Credit Shelter Trust[sm]

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Most people love and wish to benefit their descendants with their wealth. Some may have the resources to give property during their lifetimes to their children and grandchildren. But often they will not feel comfortable in transferring nearly all of their wealth before they die, even if that would enhance what their descendants receive. Instead, most married people feel it is important to devote their wealth to their spouse first and have their property pass on to their children and grandchildren only when they and their spouse have both died.

Two Shares at Death for the Surviving Spouse. Of course, even in such a case, an estate plan can be designed to minimize the taxes paid at each spouse's death. For example, many married people divide their estates at death into two broad shares. One share is equal to the amount that can be protected from estate tax by the estate tax exemption (which is based on the unified or applicable credit determined under Section 2010 of the Internal Revenue Code). This share typically will be placed in a trust called the "credit shelter" or "estate tax exemption" trust. That trust may also be called a "bypass" trust because it passes by the estate of the surviving spouse for estate tax purposes when he or she later dies. The second share typically is protected from estate tax when the first spouse dies not by the exemption (which is used to protect the first share from tax) but by the unlimited estate tax marital deduction. Property in excess of the estate tax exemption can pass to the surviving spouse (or to a marital deduction trust that benefits only the spouse) with no estate tax at the first spouse's death, and property not consumed or given away before the survivor dies will be subject to estate tax. This structure eliminates estate taxation until the survivor's death and should minimize overall tax.

Lifetime Estate Planning with a Grantor Trusts. A common estate planning strategy for many relatively wealthy individuals is to give property away during lifetime to a trust that is a

"grantor trust" but that will not be included in the grantor's estate when he or she later dies. A grantor trust is a trust that has its income attributed to the trust's creator pursuant to Section 671 of the Internal Revenue Code. One of the great benefits of a grantor trust is that the grantor must pay the income tax on the trust income but is not treated as making a gift to the trust when he or she does so. See Rev. Rul. 2004-64. That permits the trust assets to compound (or grow) on an income tax free basis. As Albert Einstein observed, compounding is the most powerful force in the universe, and tax-free compounding is often the most powerful aspect of growing wealth. However, grantor trust status terminates when the grantor dies, which typically means the tax free compounding ends when a married person dies as to property he or she has left to his or her surviving spouse. In other words, there is not generally a way to have continued tax-free growth in a trust like the credit shelter trust described above – which avoids estate taxation at the death of both spouses - after the first spouse dies.

Keeping Grantor Trust Status Going After the Death of One Spouse. Nonetheless, it seems a couple can – with careful planning – "supercharge" a credit shelter trust created for the surviving spouse when the first spouse dies by having the credit shelter trust be a grantor trust as to the surviving spouse. The means the credit shelter trust can continue to grow, free of income tax, until the surviving spouse dies by using the "Supercharged Credit Shelter Trust[sm]," while still avoiding inclusion and tax at the survivor's death.

Building a Supercharged Credit Shelter Trust[sm]. The Supercharged Credit Shelter Trust[sm] is set up by starting with a lifetime QTIP marital deduction trust, instead of a traditional estate planning document that would be effective only at death. Each spouse (or the spouse whom you're positive will be the survivor) can create this trust for the other. No gift tax will be due because the trust will qualify for the gift tax marital deduction under Section 2523 *as long as the spouse who is the beneficiary is a US citizen*.

A QTIP trust created for a client's spouse will be a grantor trust as to the spouse who creates the trust, not the spouse who is the beneficiary of the trust. So if Spouse 1 creates a QTIP trust for Spouse 2, the trust will be a grantor trust as to Spouse 1. That means the QTIP trust (and Spouse 2, who is its beneficiary) will not have any taxable income—trust income will all be attributed to Spouse 1, who created the QTIP trust. Now that isn't very exciting initially, as the couple's income tax burden will remain the same (assuming they file a joint income tax return). And the fact that the QTIP trust will grow tax free doesn't mean much, since it will be included under Section 2044 in the gross estate of Spouse 2 at death in any event.

But here is an important difference: the lifetime QTIP trust as mentioned above is a grantor trust as to the spouse who created it – Spouse 1. And Spouse 1 will continue to be the grantor when Spouse 2 (who is the beneficiary of the trust) dies, **even though the trust will be included in the gross estate of Spouse 2.** The assets in the QTIP trust, because they are included in Spouse 2's gross estate, can be used to fund a credit shelter trust for the benefit of Spouse 1, who was the creator of the QTIP trust. In our example, Spouse 1 who created the QTIP trust for Spouse 2 will remain the income tax grantor of the QTIP trust even though it is included in the gross estate of Spouse 2. And if the QTIP trust assets are directed to pass to a credit shelter trust for the benefit of Spouse 1, that credit shelter trust will be a grantor trust as to Spouse 1. Hence, the credit

shelter trust, which will not be included in the gross estate of Spouse 1 at death, will grow free of income tax because it remains a grantor trust as to Spouse 1.

An added bonus is that before Spouse 1 dies, he or she can substitute high basis assets for low basis assets in the credit shelter trust without any gain recognition. Rev. Rul. 85-13. This substitution can secure the equivalent of a step-up in income tax basis for highly-appreciated property, saving income tax if that property is sold after both spouses have passed away.

This is a complicated strategy but it is worthwhile for married couples who want to benefit their descendants to a greater extent than using a standard testamentary Marital Deduction/Credit Shelter Trust estate plan for the estate of the first spouse to die.

Lawyers affiliated with InterActive Legal developed the concept of the Supercharged Credit Shelter Trust[sm] and the Wealth Transfer Planning drafting system includes a form of the trust. For more information about the Supercharged Credit Shelter Trust[sm], see Gans, Blattmachr, & Zeydel, "Supercharged Credit Shelter Trust[sm]," Probate & Property, p. 52, July/August 2007.