Does the American Taxpayer Relief Act Eliminate the Need for Credit Shelter Trusts?

By: George L. Schoenbeck, Sosin & Arnold, Ltd.

Regardless of their areas of focus, most lawyers find themselves working with lifetime revocable trusts in some fashion. Real estate lawyers regularly transfer clients' property to such trusts. Divorce matters often require family lawyers to account for the assets held by these instruments and to scrutinize their terms. Even if you do not practice estate planning, clients whose trusts inevitably become part of your representation rely on you to have at least a basic understanding of their functions and purposes. Often, married couples whose estates could become subject to estate taxes upon their deaths utilize a particular type of lifetime revocable trust commonly known as the "credit shelter" trust or "A-B" trust to reduce their estate tax liabilities. 26 USC § 2010 grants every decedent a unified estate tax credit of an amount calculated to render the "exclusion amount" ($5,250,000 in 2013) exempt from tax. In other words, everyone receives a tax credit sufficient to permit the first $5,250,000 of assets they own at death to pass tax free. The exclusion amount is indexed for inflation and is subject to a change on an annual basis on account thereof. Credit shelter trusts reduce taxes by enabling their grantors to use part or all of the unified credits of both spouses while simultaneously rendering some of those assets not includable in the gross estate of the surviving spouse upon his or her death. The American Taxpayer Relief Act, Pub. L. 112-240 (2012) (the "ATRA"), made permanent the concept of "portability", which allows a surviving spouse to use the unused unified credit of his or her deceased spouse without the use of a credit shelter trust. From a federal estate tax perspective, portability arguably alleviates the need for credit shelter trusts entirely. However, despite the availability of portability, state estate tax considerations, administration issues, possible changes in tax laws and general estate planning considerations

render credit shelter trusts very much a necessity for married clients with potentially taxable estates.

The Mechanics of Credit Shelter Trusts

To illustrate how a credit shelter trust works, consider a married couple, Dick and Jane, who each own, individually, assets worth $3,500,000. For purposes of this example, presume portability does not exist. Dick dies in February, 2013 while Jane dies in October, 2013. If they each have only simple wills or trusts that leave all of their property to each other, Jane will inherit all of Dick's property and will pay no estate tax. 26 USC § 2056 permits an unlimited deduction against a decedent's gross estate for all property passing to a surviving spouse (the "marital deduction"). Dick's entire unified credit will go unused because all of his bequest to Jane would qualify for the marital deduction. Jane will now have a gross estate of $7,000,000 by herself and, upon her death later that year, will incur federal estate taxes on $1,750,000 of her assets. The federal estate tax would total $645,800. Even if Dick's executor did not claim the marital deduction on his estate tax return and, instead, used Dick's unified credit, all of their collective property will still be includable in Jane's gross estate and the federal estate tax due would remain the same.

A credit shelter trust seeks to avoid this circumstance by utilizing some or all of the unified credit of the first spouse to die by funding a sub-trust that will not be included in the surviving spouse's gross estate. Like the vast majority of revocable trusts, credit shelter trusts are typically administered for the benefit of the grantor during the grantor's life and the grantor serves as trustee during that time period. The spouse of the grantor would execute a similar trust. Upon the death of the first spouse to die, the successor trustee divides the decedent's trust into two trusts—a marital trust and an exempt trust. Funding formulas vary depending on the size

and complexity of the estate and the family's objectives. A formula designed to minimize federal estate taxes to the greatest extent possible would fund the exempt trust up to the exclusion amount and fund the marital trust with the balance. The marital trust could be distributed outright to the surviving spouse or held in trust for his or her benefit. The estate of the deceased spouse incurs no tax on funds passing to the marital trust because the trust qualifies for the marital deduction. The martial trust will be includable in the gross estate of the surviving spouse.

The exempt trust, however, will <u>not</u> be included in the surviving spouse's gross estate. Even so, the trust can still be administered for the benefit of the surviving spouse to a limited extent during his or her life, even if the surviving spouse serves as the successor trustee of that trust. The trust may pay all of its income to the surviving spouse and may distribute principal to the surviving spouse for his or her health, education or maintenance in reasonable comfort. 26 USC § 2041. The remainder would go to the grantor's children or whomever else the grantor selects. Exempt trusts typically grant the surviving spouse a limited testamentary power of appointment over the exempt trust in favor of the descendants of the grantor. These income, principal invasion and power of appointment provisions in favor of the surviving spouse could also be narrower or removed completely. In lieu of providing for the surviving spouse during his or her life, the exempt trust could distribute funds outright to the grantor's children or any other third party.

Returning to Dick and Jane, assume that they have implemented credit shelter trusts and have structured them to minimize federal estate taxes to the greatest extent possible by including a funding formula designed to fund their exempt trusts up to the exclusion amount in the year of the grantor's death. All of Dick's $3,500,000 in assets will fund his exempt trust. His marital

trust will receive nothing. Upon Jane's death, she will leave a gross estate of only $3,500,000. Neither of them will incur any estate taxes. Compare this to the previous scenario where their simpler estate plan cost them $645,800 in federal estate taxes.

The Mechanics of Portability

Referred to by 26 USC § 2010(c)(4) as the "deceased spousal unused exclusion amount", portability allows Jane, from the first example where she and Dick had only simple wills, to claim Dick's unused unified credit. In order for Jane to do so, Dick's executor must file a properly completed federal estate tax return electing to transfer Dick's unused exclusion amount within nine (9) months of his death. 26 USC § 2010(c)(5). The executor must file the return even if no estate tax return is otherwise due. Id. The IRS will grant an automatic six-month extension of that time period. However, the request for an extension must be filed within that initial nine-month time period. If the executor fails to timely file the estate tax return, the surviving spouse will lose the ability to utilize the first spouse's unused unified credit. Id. Provided Dick's executor timely files a properly completed estate tax return electing to transfer Dick's unused unified credit to Jane, Jane's estate will incur no estate taxes upon her death in the first example where she and Dick had only simple wills.

Portability Will Not Supplant Credit Shelter Trusts
As the Primary Testamentary Estate Tax Minimization Strategy for Married Couples

Unfortunately, the federal government is not the only entity that levies estate taxes. Under the Illinois Estate and Generation-Skipping Transfer Tax Act, 35 ILCS 405/1 et seq., the State of Illinois assesses an estate tax and that Act does not authorize portability for Illinois estate tax purposes. A couple relying on federal portability as a means of dodging estate taxes may find that the surviving spouse will owe Illinois estate taxes, but no federal taxes, due to this

inconsistency between the two taxing schemes. This discrepancy alone requires married couples with potentially taxable estates to continue to use credit shelter trusts instead of portability as their primary testamentary[1] estate tax reduction strategy.

Credit shelter trusts generally permit taxpayers greater flexibility in dealing with other inconsistencies between the federal and state estate tax regimes as well. Illinois' exclusion amount is only $4,000,000. 35 ILCS 405/2(b). Most credit shelter trusts contain provisions permitting their trustees to take advantage of the Illinois-only qualified terminable interest property ("QTIP") election permitted by 35 ILCS 405/2(b-1). In essence, this election allows taxpayers to have their cake and eat it too. A trustee could fund the exempt trust up to the federal exclusion amount and then make an Illinois-only QTIP election over the difference between the federal exclusion amount and the state exclusion amount, $1,250,000 in 2013. For federal tax purposes, the full $5,250,000 in the exempt trust will be excluded from the gross estates of both the husband and wife. $4,000,000 will be excluded from the gross estates of both spouses for state tax purposes. The trustee will create a sub-trust of the exempt trust to hold the $1,250,000 to which the Illinois-only QTIP election pertains. That property will be included in the surviving spouse's Illinois gross estate (provided he or she remains an Illinois resident) and must be administered solely for the benefit of the surviving spouse for the remainder of his or her life in accordance with 26 USC § 2056(b)(7).[2] These capabilities inherent in most credit shelter trusts enable trustees to dodge estate taxes completely upon the death of the first spouse while using the maximum available exclusion amounts of that deceased spouse for both federal and

[1] The word "primary" is qualified by the term "testamentary" here because lifetime gifting strategies can be more effective than credit shelter trusts in minimizing estate taxes.

[2] The foregoing strategy in addressing the inconsistency between the Illinois and federal exclusion amounts is one of several strategies possible through the use of credit shelter trusts. A full discussion of those strategies is beyond the scope of this article.

state purposes. Such post-mortem planning opportunities are not available to an executor or trustee administering a simpler, portability-reliant estate plan.

Relying on portability carries a certain amount of risk. As discussed above, the executor of the first spouse to die must timely file a properly completed estate tax return and elect to claim the unused unified credit thereon. 26 USC § 2010(c)(5). A surviving spouse who lacks sufficient advisors could fail to meet this requirement and would forever lose the ability to claim the deceased spouse's unused unified credit.

Relying wholly on portability is also relying on the permanence of the gift and estate tax laws as they now exist. Suffice to say that many estate planners chuckle a bit when the words "permanent" and "tax law" are used in the same sentence. Portability is an abstract and complex concept. If it is repealed, couples who previously completed their estate plans relying on it may not realize that they must revise those plans.

A client's estate planning desires and circumstances may also render portability-based estate plans using only simple wills or trusts inadequate as a substitute for credit shelter trusts. Consider a husband and wife in second marriages. Each spouse has adult children from a prior marriage and they each want their estates to ultimately pass to their children. However, they would like part of the estate of the first to die to remain available to support the survivor for the rest of his or her life. These individuals would need to rely on credit shelter trusts in order to carry out these plans in the most tax-advantageous manner. In many circumstances, relying on portability with a simple estate plan will not adequately address a client's estate planning needs.

None of this is intended to construe portability as worthless. The mechanism could save couples who fail to plan for estate taxes while they are both alive significant federal estate taxes. In other cases, it serves as a backup plan where decedents fail to adequately fund their credit

shelter trusts and instead have significant assets passing through joint tenancy or other means outside of their trusts.

Although it serves as a welcome addition to the Internal Revenue Code that will be of some use to estate planners, portability fails to address many of the issues handled by revocable credit shelter trusts. Illinois' divergent estate tax scheme, portability's administrative pitfalls, the potential for changes in federal estate tax laws and, in many cases, general estate planning considerations require the continued use of credit shelter trusts as a means of maximizing a couple's use of its unified credits.