



Up your estate tax exemption ante with a credit shelter trust

Think of your estate tax exemption as a “do not pay taxes” card that, under current law, allows you to transfer at your death \$2 million worth of assets without paying estate tax. But the “card” isn’t transferable. So if you bequeath everything to your surviving spouse (automatically tax-free under the marital deduction if your spouse is a U.S. citizen, easily made tax-free if your spouse is not a U.S. citizen), your \$2 million “card” doesn’t get played at all.

Your assets will be included in your spouse’s estate, and only your spouse’s own \$2 million “card” can be used at his or her death. A credit shelter trust allows both your and your spouse’s “cards” to be played so that you can pass up to twice the exemption amount tax-free to your children or other loved ones.

Rules of the game

If your and your spouse’s combined gross estate exceeds — or is likely to exceed — a single exemption, a credit shelter trust should likely be part of your game plan. Be aware that your gross estate generally will include all assets you have any interest in at death — including some you may not have considered, such as life insurance proceeds for policies owned in your name, retirement accounts and 50% of jointly owned property.

How does a credit shelter trust work? At your death, assets equal in value to the estate tax exemption are placed in the trust to be held for your surviving spouse and, ultimately, other heirs. The trust provides income to your spouse during his or her lifetime and can provide principal payments if needed.

Assets allocated to the trust — including growth — aren’t considered part of the surviving spouse’s estate. The estate tax exemption of the first spouse to die “shelters” these assets from estate tax when they are distributed to heirs on the surviving spouse’s death.

For example, Tom and Patricia — married with five children — have a combined total estate of \$4 million when they decide to include a credit shelter trust in their estate plan. Tom holds \$3 million of assets in his name, and he transfers \$1 million to Patricia (gift-tax-free under the marital deduction) so that they each hold \$2 million. Tom dies in 2006, and his assets are transferred to a credit shelter trust.

Patricia uses the income payments from the credit shelter trust plus funds from her own assets to maintain her lifestyle without tapping into the credit shelter trust’s principal. Patricia dies in 2008, and her taxable estate includes only the \$2 million of assets in her name, which pass tax-free to the children, protected by her estate tax exemption.

The assets in the credit shelter trust — which have grown to \$2.5 million — are excluded from Patricia’s taxable estate and also distributed to the children tax-free. The children each enjoy a total distribution of \$900,000.

Without the credit shelter trust, the \$4.5 million would have been taxable in Patricia’s estate, resulting in federal estate taxes payable in the amount of approximately \$1,125,000. \$3,375,000 would have been left with the children, with each receiving \$675,000 — \$225,000 less than with the credit shelter trust in place.

Play your cards right

When creating a credit shelter trust, there are issues to consider. For example, should your surviving spouse act as sole trustee or should a co-trustee be appointed?

Your decision likely will be based on several factors, such as whether your spouse has investment experience. If not, appointing a co-trustee may be wise. Another benefit of appointing a co-trustee is that the trust can distribute funds to your spouse under broad standards, such as for his or her “best interests,” without causing any estate tax problems.

If your surviving spouse acts as sole trustee, however, the trust can distribute funds to him or her under only narrower, “ascertainable” standards, such as for “health, education, maintenance and support.” If your spouse is sole trustee and distributes funds to him- or herself for his or her “best interests,” the trust assets will be included in his or her estate for federal estate tax purposes.

Another issue to consider is which assets your surviving spouse should use first. Generally, the survivor should use assets held in his or her name before using credit shelter trust assets. Why? Because the survivor’s assets will be included in his or her estate for federal estate tax purposes but the assets in the credit shelter trust — including growth — won’t be. For this reason, also consider investing credit shelter trust assets for growth and your surviving spouse’s own assets for income.

A winning hand

Creating a credit shelter trust involves many details, from how it’s structured to appointing a trustee. To ensure that the trust is customized to your needs, consult a professional estate planning advisor. With proper planning, a credit shelter trust can give you a winning hand.

Matters of trust

Consider allowing your surviving spouse to direct the distribution of the credit shelter trust’s assets among your descendants as he or she deems best by giving him or her a limited power of appointment. The purpose of the power of appointment is to allow the survivor to re-evaluate the ultimate disposition of the credit shelter trust assets, and modify them accordingly.

This can help address unforeseeable circumstances that arise. For instance, on your surviving spouse’s death, it may be desirable to treat your adult children unequally if one child has a child with special needs who will require a lifetime of care.

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