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Credit Shelter Trust

September 27, 2006

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Summary:

When an individual leaves his or her entire estate to a surviving spouse, assets pass free of federal estate tax under the unlimited marital deduction. When the surviving spouse dies, his or her estate passes free of estate tax to the extent of the surviving spouse's available exemption. In this case, the couple's combined taxable estates may be higher than need be, because the exemption of the first spouse to die has not been used.

A credit shelter trust, also called a bypass trust, can solve this problem. The first spouse to die funds a credit shelter trust with assets equal in value to his or her available exemption. Those assets bypass (hence the term bypass trust) the surviving spouse's estate (though the surviving spouse is still able to benefit from them), and pass to descendants estate tax free under the exemption of the first spouse to die.

What is a credit shelter trust?

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

How does a credit shelter trust work?

Typically, a credit shelter trust is funded with assets sufficient to fully utilize the federal estate tax exemption (also called the applicable exclusion amount--$2 million in 2006; $1.5 million in 2005) of the first spouse to die. The trust may be funded during the spouses' lifetimes or at the death of the first spouse to die.

The surviving spouse can only be 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 will be included in his or her estate when he or she dies, negating the 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.*

Tip: *The separate wills or living trusts of both spouses should provide that, at the death of the first spouse to die, assets are to pass to an irrevocable credit shelter trust up to an amount equal to the deceased spouse's available exemption. The couple may have to equalize their estates so that the trust can be fully funded by the first estate.*

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

Suitable clients

- Spouses with combined assets that exceed twice the applicable exclusion amount ($4 million in 2006)

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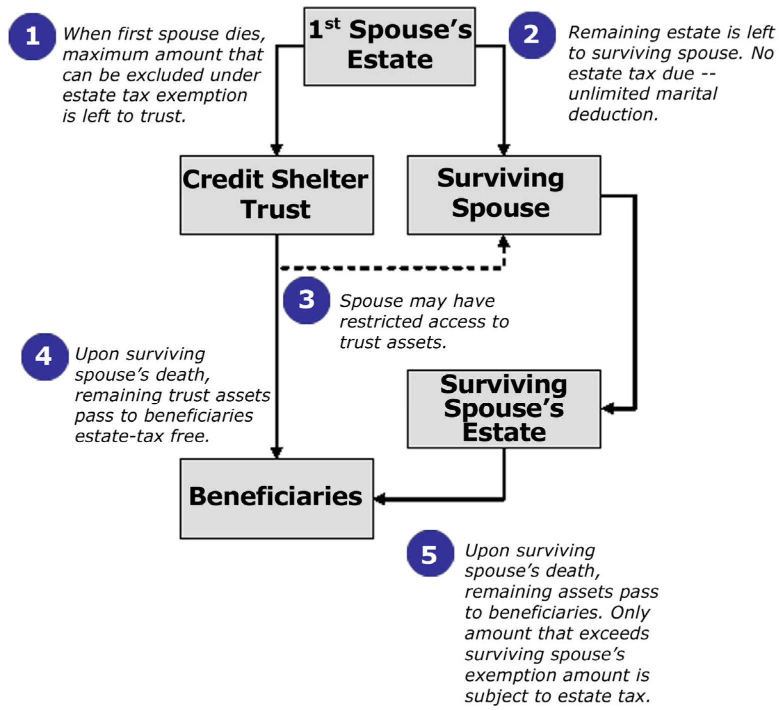

Example

John and Mary are a married couple who own a home worth $1 million and have life insurance with death benefits of $1 million, $300,000 in a retirement plan, a business interest valued at $1,200,000, and other investments totaling $500,000.

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. Now assume that Mary lives off the earnings of her $4 million estate for the rest of her life. When Mary dies, her entire estate will pass to their children. If Mary were to die in 2006, $2 million of Mary's estate would be exempt, but the excess over the exemption, $2 million, would be subject to taxes at an effective tax rate of 39%. That means that $780,800 would go to the IRS and $1,219,200 would go to John and Mary's children (assuming no other variables).

Now, lets 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 died in 2005. John's gross estate was $2 million ($4 million divided by 2). $1.5 million passed to the trust tax free under John's exemption, and $500,000 passed directly to Mary tax free under the marital deduction. Mary can live off the earnings of her $2 .5 million estate ($2 million plus $500,000), 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 were to die in 2006, Mary's estate would be $2.5 million; the assets in the trust would not be included in her gross estate. John and Mary's children would receive the entire corpus of the trust. Of Mary's $2 .5 million estate, $2 million would pass to their children tax free under Mary's exemption, and $500,000 would pass subject to tax at an effective rate of 31 percent. That results in $155,800 going to the IRS and $1,944,200 going to John and Mary's children.

By using a credit shelter trust, John and Mary's children receive an additional $725,000 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.*

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.

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