Credit Shelter Trusts and "Portability"

Comparing strategies to help manage estate taxes

Married couples have two strategies to choose from to help protect their families from estate taxes if both individuals should die in 2011 and 2012. Choosing the appropriate strategy requires an understanding of their advantages and disadvantages.

In 2012, federal estate taxes are imposed when an individual's taxable estate exceeds the "applicable exclusion" ($5,120,000 in 2012). However, married couples do not automatically get the benefit of two exclusions. A married couple can avoid federal estate tax on estates worth up to twice the applicable exclusion ($10,240,000) – but to do so, they must use one of two available strategies:

- Planning in advance by including "credit shelter trust" provisions in each spouse's will or living trust.
- Waiting until after one spouse dies and making a special tax election to "transfer" the deceased spouse's applicable exclusion to the surviving spouse. This is sometimes referred to as a "portability" election.

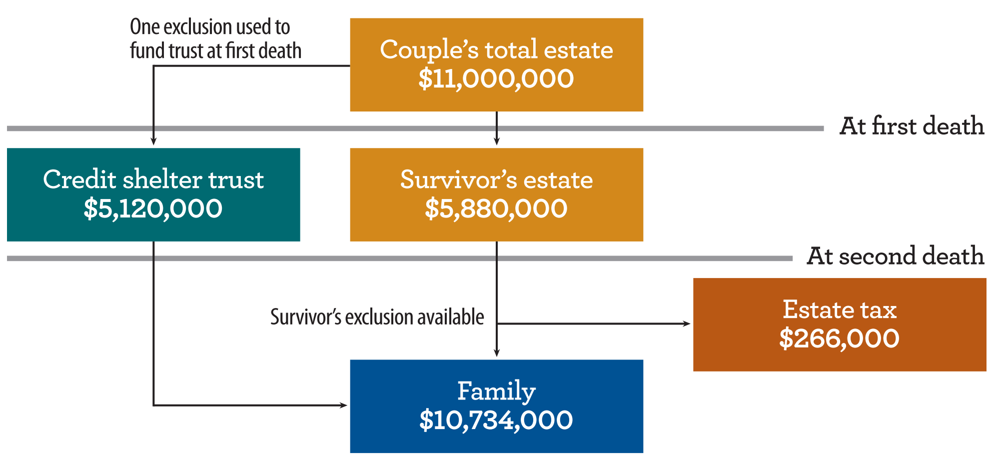
Using one of these strategies is important because, at today's 35% flat estate tax rate, being able to protect an additional $5,120,000 could potentially mean $1,792,000 in estate tax savings.

This report examines both strategies and their potential advantages and disadvantages.

Credit shelter trust planning

The credit shelter trust has many different names. It is referred to as a "bypass" trust, the "B" trust in an "A-B" trust plan or the "family" trust in a "family/marital" trust plan.

Credit shelter trust example



Is credit shelter trust planning right for you?

This strategy may fit if ...

- You are married and you and your spouse have a combined estate in excess of the federal basic exclusion
- You are married, live in a state that imposes its own state estate tax and your combined estate is likely to exceed the level at which your state's estate tax applies

This strategy may not fit if ...

- You are married and your combined estates are unlikely to be subject to either federal or state estate taxes
- You are single

How it works

The provisions to create a credit shelter trust must be included in the wills or revocable living trusts you and your spouse create. However, the credit shelter trust does not actually come into being until one spouse dies. At that time, the will or living trust directs the executor or trustee to set aside, in trust, an amount equal to the applicable exclusion then in effect.

The surviving spouse can receive all of the income from the credit shelter trust. He or she can also have access to principal, according to standards that you set. Maintaining the surviving spouse's financial security is usually the trust's principal purpose. (If you wish, distributions to others can also be permitted.) When the surviving spouse dies, any remaining principal can be distributed to children or remain in trust for their benefit, as you direct.

Even though the surviving spouse has access to income (and principal, if needed), the assets in the credit shelter trust are not considered part of the survivor's taxable estate. This is important because, if the credit shelter trust continues to grow, its entire value – both the original value plus any growth – is sheltered from estate taxes at the second spouse's death.

How it is implemented

Your attorney can prepare your will or living trust to include the necessary provisions and design your trust in a way that's most appropriate for your family situation and personal objectives.

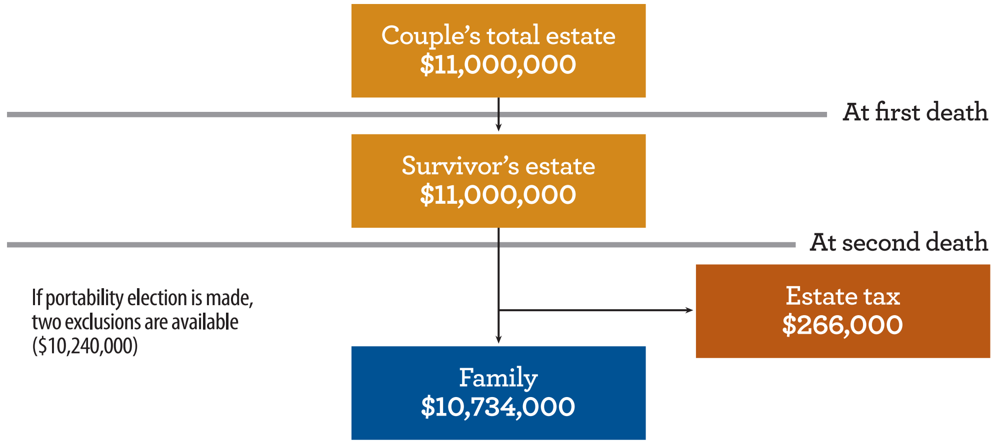
If you live in a state that imposes its own estate tax, special planning may be necessary. In a number of states, the available state exclusion is lower than the federal exclusion. Your attorney can help you design a plan that takes into account the differences between the federal and state exclusion amounts.

Once you have the necessary provisions in your will or trust, it is important to ensure that sufficient assets pass under your will or trust. When you create your will or trust, talk with your attorney about how to structure asset ownership, title accounts and make beneficiary designations. Your Financial Advisor can help you implement your attorney's recommendations.

Portability election

The 2010 tax legislation introduced a new planning opportunity for married couples. Under current law, these portability rules are effective only in 2011 and 2012, but Congress could extend them. By using them, it's possible to transfer a deceased spouse's "unused" basic exclusion to the surviving spouse. Instead of removing assets from the survivor's taxable estate (as with credit shelter trust planning), portability has the effect of increasing the applicable exclusion at the second spouse's death.

Portability example



How it works

Unlike credit shelter trust planning, which depends on documents you must create before death, this approach depends on action taken after one spouse dies. To qualify for this treatment, the deceased spouse's executor must file a timely and complete estate tax return (even if no estate tax is due). Keep in mind that preparing the estate tax return may involve significant legal, accounting and appraisal costs. This return is due nine months after death. The deceased spouse's executor has the power to decide whether or not to make this election.

Part of portability's attraction is that it does not require a sophisticated will or trust. You could simply make an outright transfer of everything you own to your spouse. This could be done through a will, revocable trust, beneficiary designation, transfer-on-death (TOD) designation or joint tenancy with right of survivorship. Alternatively, you could leave assets to a trust that would qualify for the marital deduction. Of course, transfers of this type will increase the survivor's taxable estate, but if the portability election is made, the surviving spouse will also have a larger applicable exclusion.

The deceased spouse's exclusion can only be transferred to a surviving spouse. It cannot be given to other family members or beneficiaries. It is possible for the transferred exclusion to be greater than the deceased spouse's assets. For example, let's say that an individual with a $2 million taxable estate transfers his or her entire estate to the surviving spouse. If the deceased spouse's executor files an estate tax return, the surviving spouse would be entitled to the deceased's spouse's full $5,120,000 applicable exclusion.

Only the "unused" exclusion can be transferred to a spouse. Any transfers to a non-spouse will typically use up part of the deceased spouse's exclusion. For example, if the first spouse to die transfers some assets to children or other individuals (or trusts for their benefit), that will use up part of his or her exclusion.

Risks when using portability

Remember, under current law the portability rules are only effective if both spouses die during 2011 and 2012. But even if the rules are extended beyond 2012, this strategy would carry some risks:

Someone has to file an estate tax return, even if no tax is due. For portability to work, you are depending on someone to:

- Be aware that an important tax decision needs to be made after your death
- Get help from a knowledgeable attorney or tax advisor
- Be willing to incur the extra costs necessary to file a timely and complete estate tax return

Survivors might not be aware of this important tax issue, could forget to make the election or be unwilling to incur the expense of preparing an "optional" estate tax return. If someone other than the surviving spouse is named as executor, it's possible that a difference of opinion, conflict of interest or family squabble could result in the election not being made. If you want a portability election to be made, it's important to choose your executor carefully.

It is possible for the transferred exclusion to be lost. Tax rules provide that the surviving spouse can only use the additional exclusion transferred from his or her "most recently deceased" spouse. So under some circumstances, the transferred exclusion can be lost. Here's an example:

1. Art and Jane are married. Art dies and leaves all his assets to Jane.
2. An election is made to transfer Art's unused exclusion to Jane. So Jane now has $10,240,000 of available exclusions (Jane's own $5,120,000 plus an additional $5,120,000 from Art).
3. Jane subsequently marries Richard.
4. Richard dies and uses all of his available exclusion to transfer property to his children from a prior marriage.
5. Jane now has only her own $5,120,000 exclusion. As a result of Richard's death, she has lost the exclusion transferred from Art.

It's easy to think that "I would not get married again" or "my spouse wouldn't remarry," but life does not always turn out the way we expect. So it's appropriate to consider the possibility that the transferred exclusion could be lost.

Once the exclusion is transferred, it does not grow. The assets transferred to a surviving spouse could grow significantly in value over time. But the transferred exclusion is fixed. So, making a portability election may not be optimal if the survivor lives for many years after the first spouse dies.

Portability does not apply to the generation-skipping tax (GST) exemption. While the estate tax applicable exclusion is transferable, the GST exemption is not. This could be a significant drawback for wealthy families. When traditional credit shelter planning is used, it's possible to make use of both spouses' $5,120,000 GST exemptions, potentially sheltering $10,240,000 from a future generation's estate tax. If portability is used, only one GST exemption is available.

Is portability right for you?

This strategy may fit if ...

- You have a potential taxable estate but want the simplest estate plan possible, even if this does not take full advantage of estate-tax-saving opportunities
- You have a potential taxable estate but don't want to split asset ownership between spouses
- A large portion of your estate consists of retirement plan or IRA assets, you lack sufficient non-retirement assets to fill a credit shelter trust and you would prefer for income tax reasons to name your spouse as primary beneficiary of those retirement assets
- Your spouse and executor are fully aware that it is critical to make the portability election after the first spouse's death

This strategy may ***not*** fit if ...

- You expect your assets will continue to appreciate in value after your death
- You live in (or might move to) a state that imposes its own estate tax
- It's important to your family to use both spouses' GST exemptions
- You want to protect against the possible loss of a transferred exclusion
- You are concerned that survivors might forget or neglect to make the required election after your death

State exclusions are not portable. Portability applies only to federal estate taxes. State exclusions cannot be transferred. So if you live in a state that imposes its own estate tax, portability may not be an optimal choice.

Situations in which portability may be useful

Even though portability has drawbacks, it could be a useful planning tool in situations where it is impossible or inconvenient to "split" ownership of an asset between two spouses. For example:

- Alice owns a $4,500,000 IRA and real estate valued at $500,000. Her husband, Bernard, owns a $2 million IRA and $6 million in marketable investments. They also own their home, valued at $1 million, as joint tenants with right of survivorship. Both Alice and Bernard are age 61. Alice's CPA pointed out that if Alice was the first spouse to die, she might prefer to name Bernard as her IRA beneficiary for income tax planning reasons. Bernard could roll over the IRA and defer distributions until after reaching age 70½. However, if Alice's IRA passed to Bernard directly, there would only be $500,000 remaining to fund a credit shelter trust. But if Alice's executor makes a portability election after her death, her unused exclusion can be transferred to Bernard.
- Carol is a part owner of her family's business; her share is valued at $7 million. She also owns other assets valued at about $1 million, and her husband, David, owns assets valued at about $2 million. Carol is 71, and David is 79. Carol's family has owned the business for three generations. They feel strongly that the ownership must stay "in the family," so her shares are subject to a written buy-sell agreement that prevents a transfer to spouses or other nonfamily members. The planning dilemma is that if David dies first, he does not have sufficient assets to fully use his $5,120,000 basic exclusion, which could lead to a higher estate tax at Carol's death. Portability provides a potential solution. If David is the first to die, a portability election can be made to transfer his unused exclusion to Carol.

Of course, if portability rules expire at the end of 2012, they would not help in either of these examples.

How it is implemented

- After the death of one spouse, the executor must file a timely and complete estate tax return. The term "portability" is not actually used in the tax code; instead, this is referred to as an election to transfer the "Deceased Spouse Unused Exclusion Amount" (DSUEA).
- The surviving spouse will need make sure that copies of the estate tax return are not lost or misplaced because the heirs, executors or successor trustees will eventually need to know the amount of additional exclusion that was transferred.
- If the surviving spouse makes gifts that would require the filing of a gift tax return, the tax preparer will need to know about the DSUEA election.
- If the surviving spouse considers remarriage, the availability of (and risk of losing) the DSUEA could be an important factor in planning.

In summary

For now, portability is effective only if both spouses die during 2011 and 2012. If these rules are extended, portability will be a useful tool that will offer additional planning flexibility to married couples. However, in many cases, traditional credit shelter planning will continue to be the preferred approach for married couples who want to use both of their applicable exclusions.

Comparing the strategies

Consideration	Credit shelter trust	Portability
Advance planning required	Yes. Requires properly drafted wills or trusts and attention to asset titling.	No. but executor's election on estate tax return is required.
Low initial cost	No. Involves legal fees to create will or trust; there could also be costs to retitle property.	Yes. However, future costs will be incurred to file estate tax return and make portability election.
Step-up in basis at surviving spouse's death	No.	Yes.
Tax-efficient for qualified retirement plan and IRA assets	Not ideal. May lose maximum "stretch" potential; requires careful trust drafting to qualify.	Yes. Spouse could do rollover and select new beneficiaries.
Recognized for state estate tax planning	Yes, but additional planning is required if state exclusion is less than federal exclusion.	No. No state tax at first death because of marital deduction, but value is subject to state taxes at second death.
Applicability	Indefinite.	2011 and 2012 only, unless extended.
Asset growth shielded from estate tax	Yes.	No.
Controls asset disposition during surviving spouse's lifetime	Yes.	No.
Controls asset disposition at surviving spouse's death	Yes.	No.
Creditor protection	Yes, although this may vary depending on trust terms and state law.	No.
Ability to "lock in" at first death *(i.e., nonforfeitable)*	Yes.	No. Transferred exclusion may be lost if surviving spouse remarries and new spouse dies.
Ability to allocate GST exemption	Yes.	No. *(GST exemption is not portable.)*
Estate tax return filing required at first death	Only if estate of first spouse to die exceeds $5,120,000.	Yes, regardless of estate size.
Ensures future probate avoidance	Yes, for amount in credit shelter trust.	No *(although surviving spouse could take other planning steps to avoid probate).*

Evaluate strategies in light of your values and life goals

As you evaluate any advanced planning strategy, ask yourself:

- Does it reflect my values?
- How does it affect my income and financial security?
- Is it consistent with my time horizon, risk tolerance and financial situation?
- Will it help accomplish my goals?
- Does it build the type of legacy I want?
- How does it affect the people I care about most?

If you're married and believe your estate may be subject to estate taxes, we encourage you to begin a conversation with an estate planning attorney and your Financial Advisor.

Frequently asked questions

I thought I could leave everything to my spouse without incurring estate taxes. Why not just do that?

It's true that you can leave an unlimited amount to your spouse with no estate tax due to the unlimited marital deduction. However, this simply defers the estate tax problem until the second spouse dies. If nothing is done, the surviving spouse will only have one exclusion available, and everything above that amount will be subject to estate tax. For married couples with estates valued at more than $5,120,000, it's important to either do credit shelter trust planning or make a portability election to avoid paying unnecessary estate taxes at the second death.

What assets are counted in determining my taxable estate?

Basically, everything you own or control is counted as part of your taxable estate. This includes investment assets, real estate, IRAs and retirement plans, and the death benefits from life insurance that you own.

Do I have to choose between credit shelter planning or portability? Can I use both?

You can use both, but you can't double up. You only have one $5,120,000 applicable exclusion. You could apply some of that to fund the credit shelter trust and transfer any "left over" exclusion by making a portability election.

I already have credit shelter trust provisions in my will or living trust, do I need to do anything else?

Just having the language in your document is not enough because some assets are not governed by your will or trust. For example, assets held in joint tenancy automatically pass directly to the surviving joint tenant, not to the credit shelter trust. Assets with a beneficiary designation (retirement plans, IRAs, annuities, life insurance) will pass directly to the named beneficiary. To ensure that your estate plan operates as expected, it's important to talk with your attorney about the best way to structure asset titling and beneficiary designations.

What if the estate tax applicable exclusion changes? Will I need to change my will or trust?

If you choose to do credit shelter trust planning, your attorney can draft your trust to take advantage of the applicable exclusion in effect in the year of your death, whatever that may be. So usually, it is not necessary to amend your estate planning documents each time the exclusion changes.

Does the credit shelter trust have to pay out all income to the surviving spouse?

No. This is the most common provision, but you can permit the trustee to "sprinkle" income among your spouse, children, grandchildren and any other beneficiaries, or to accumulate income if beneficiaries do not need it.

Can the surviving spouse get principal from the credit shelter trust?

Yes. Most credit shelter trusts permit the surviving spouse to have access to principal. You can set the standards under which the trustee may distribute the principal.

Can the surviving spouse be the trustee of the credit shelter trust?

Yes, with one important condition: If the surviving spouse is also the trustee, the spouse's ability to pay principal to himself or herself must be limited by an "ascertainable standard." For example, a provision that lets the surviving spouse distribute principal for "health, education, maintenance or support" would be acceptable.

Can the surviving spouse have any control over the ultimate disposition of the credit shelter trust?

Yes, but it must be limited. The surviving spouse cannot have a "general power of appointment" (complete control over the disposition of trust principal with the ability to leave it to anyone). But if you wish, you may give your spouse a "limited power of appointment" (for example, the power to direct how trust principal will be distributed to children and grandchildren but no power to make distributions outside of that limited group).

When the surviving spouse dies, what happens to assets remaining in the credit shelter trust? Do they have to be distributed outright at that point?

When you create your trust, your attorney can include provisions directing how you want any remaining principal to be distributed after the death of the second spouse. You can direct an outright distribution to beneficiaries or direct that assets remain in trust.

How does the credit shelter trust work in a community property state?

In a community property state, each spouse is regarded as owning one-half of all assets acquired during the marriage. When one spouse dies, his or her estate includes the deceased spouse's separate property and one-half of the community property. The credit shelter trust would be funded out of the deceased spouse's estate.

I live in a state where the exemption from state estate taxes is smaller than the federal exemption. How does this affect my decisions?

Currently, the states that have their own estate tax do not recognize the portability election. So portability is not a desirable option if you live in one of these states. Credit shelter planning can be helpful, but some special planning may be needed. For example, if you live in a state where the state's estate tax exemption is lower than the federal exemption, full funding of the credit shelter trust could result in some state-level estate tax being due at the first spouse's death. It's important to talk with an attorney in your state about how to deal with this situation because what is "best" can vary widely depending on state tax laws and the specifics of your particular situation.

Can I write my will to "command" my executor to make a portability election after my death?

The only way to get the tax benefit is to file an estate tax return on time and actually make the election. Ask your attorney about whether your will should include a direction, recommendation or reminder for the executor.

If I use the portability strategy, can I control how my spouse uses my applicable exclusion?

No. You could create a marital trust to impose some control over how the surviving spouse uses the property that is transferred, but that does not control how he or she uses the exclusion. If you want to control who gets the benefit of your exclusion, talk to your attorney about using credit shelter trust planning or planning with lifetime gifts in trust.

If the estate of the first spouse to die is worth less than $5,120,000, does a portability election transfer his or her unused applicable exclusion?

Yes. For example: Edward has a $1 million taxable estate. He is married to Frances, who has a $6 million taxable estate. Edward dies and leaves all of his assets to his children from a prior marriage; this uses up $1 million of his applicable exclusion, and $4,120,000 is left unused. Edward's executor can file a portability election that transfers his unused exclusion to Frances. She now has $9,240,000 in available exclusions – her own $5,120,000 and $4,120,000 transferred from Edward.

If I die in 2012 and a portability election is made, will my spouse keep my transferred exclusion even if he or she dies after 2012?

No. Current law does not preserve or "grandfather" this benefit. If Congress does not extend portability, the transferred exclusion would simply disappear.

What if we don't have a taxable estate now? Could it still make sense to plan on setting up a credit shelter trust to take effect at the first death or to make a portability election after one spouse dies?

Possibly. These planning strategies might still be worth considering if you don't have an estate tax problem now but believe one could exist in the future. For example: George has a $2 million taxable estate. His wife, Helen, has a $2,800,000 taxable estate. Helen is an only child, and her elderly mother, Irene, has a $3 million taxable estate that she intends to leave to Helen.

Today, George and Helen have a combined net worth of $4,800,000. Even without considering the future inheritance, they might want to consider including credit shelter trusts in their estate plans if they believe that growth in their estates is likely to bring their combined net worth above $5,120,000.

It is also possible that the applicable exclusion could be reduced in the future to, for example, $3.5 million or $1 million. It could be wise for George and Helen to include credit shelter trust planning in their wills or trusts to help ensure they get the benefit of whatever applicable exclusion is available at the first spouse's death.

If portability rules are extended, there will also be situations where it is wise to incur the expense of filing an estate tax return at the first death, even if this does not produce any immediate tax savings. In our example, although George and Helen do not currently have a taxable estate, a portability election – if still available – could play an important role in helping to avoid or reduce estate taxes. For example, assume that George dies and leaves all his assets to Helen. This leaves her with a $4,800,000 taxable estate, which is still below the current applicable exclusion. It would be easy to skip the portability election, since, even after George's death, Helen does not have a taxable estate. But if George's executor has the foresight to make a portability election, Helen would then have $10,240,000 in available exclusions – her own $5,120,000 "basic exclusion" and $5,120,000 transferred from George. If Helen later receives a $3 million inheritance from her mother, her $7,800,000 estate would be fully protected from estate tax. If the portability election was not made, George and Helen's children would potentially face estate taxes because her taxble estate would be greater than her applicable exclusion.

What if estate tax laws change? Should I wait to plan until we know what tax laws will be in the future?

Tax laws are constantly changing. If you put off planning until "after the next round of tax law changes," you may never begin. It makes sense to put a plan in place now but build in flexibility to respond to future tax law changes.

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