INCOME TAX SAVINGS OPPORTUNITY: CREDIT SHELTER TRUST VS. MARITAL TRUST

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No one likes the idea of paying taxes, and having a "gross estate" for estate tax purposes does not sound desirable. In fact, however, the current transfer tax system might produce *income tax* benefits previously unattainable. If your estate and trust documents were prepared before 2013 (and perhaps even afterwards), you may wish to review your plan to be sure to maximize the "hidden benefit" of the estate tax – the income tax savings opportunity.

Until 2012, the exemption amount was not portable. In other words, each spouse had his or her own exemption, and to the degree the first spouse to die did not utilize his or her exemption, it was a wasted opportunity. For this reason, estate plans created before 2013 were designed to protect the exemption amount from future taxes at the surviving spouse's death.

Typically, this was accomplished by funding a "Credit Shelter Trust" (which might be known by various names including a "Family Trust," "Bypass Trust," "Non-Marital Trust," or a "Residuary Trust," among others). This trust, whatever it is called, could provide for the benefit of the surviving spouse but, upon that spouse's death, would escape inclusion in the spouse's estate for estate tax purposes (and therefore escape estate taxation). This was solid and prudent planning.

Effective in 2013, Congress changed this rule so that the first spouse to die could "port" his or her exemption to his or her surviving spouse. Portability changes the analysis of the tax consequences of many clients' estate planning. Under current law, the very common structure of funding a Credit Shelter Trust at the death of the first spouse to die might prove disadvantageous from an income tax perspective. Why? Because there is one advantage to having assets included in a person's gross estate for estate tax purposes: the "step-up" in basis.

If an asset is included in a person's gross estate (which means that it could be subject to estate tax if the total amount of the assets exceeds the decedent's estate tax exemption), those assets will get a new tax basis equal to their fair market values at the decedent's death. The increased basis is relevant because, when the assets are sold by the beneficiaries, the capital gain tax will be reduced, perhaps substantially. (Note, however, that the law is a two-edged sword: if the assets depreciated, their bases would "step down" and the tax loss would be eliminated.)

Example: Credit Shelter Trust

For example, assume that Husband died, survived by Wife and Child. Husband's traditional estate plan created a Credit Shelter Trust upon his death, and it was funded with marketable securities and interests in a family business totaling $5 million. The Credit Shelter Trust was held for the benefit of Wife for her lifetime. No estate tax was payable because Husband's entire estate was under his exemption amount.

Three years later, Wife died, and the assets in the Credit Shelter Trust had appreciated dramatically, to $9 million. Wife had $1.75 million of assets of her own. Wife's gross estate for estate tax purposes was $1.75 million (well below her exemption amount), so no estate tax was payable upon her death. The Credit Shelter Trust terminated and its assets were distributed to Child. Hence, Child received $1.75 million from Wife and $9 million from the Credit Shelter Trust.

Every asset Child received from Wife had a basis equal to its fair market value at Wife's death, but the assets from the Credit Shelter Trust had a "transferred basis" of $5 million. When Child sells these assets, he will recognize a capital gain of $4 million. Capital gains currently are taxed at 20%, but they also are deemed to be "net investment income," so the 3.8% tax applies as well. And if Child lives in a state with an income tax of 6%, the result is that the applicable tax rate is nearly 30% (and this is before Alternative Minimum Tax). If Child were to sell the assets he received from the Credit Shelter Trust, he would owe on the order of $1.2 million in taxes.

Example: Marital Trust

If, however, Husband left his assets outright to Wife – or preferably in a special Marital Trust for Wife's benefit – the result would be substantially different. In that case, Wife's gross estate for estate tax purposes would be $10.75 million. But because of the portability of Husband's estate tax exemption, between her own exemption and Husband's, she would have at least $10.98 million (under 2017 law) of exemption. Thus, upon Wife's death, Child would receive $10.75 million – all with a basis equal to $10.75 million. Effectively he would save nearly $1.2 million in income taxes by his parents' careful planning with the estate tax.

What if I want additional beneficiaries beyond my spouse?

The foregoing example makes clear the tax planning advantage available in situations in which spouses wish to benefit (only) each other upon the death of the first of them to die. Leaving everything to the surviving spouse is not always the goal, however. Some clients desire to structure their estate plans so that assets may be available not only to the surviving spouse but also to their children or grandchildren. In these cases, the traditional planning of a Credit Shelter Trust is necessary, since the Marital Trust must be held exclusively for the surviving spouse and no distribution may be made to any other person. A Credit Shelter Trust can include anyone as a beneficiary.

Additional Planning Considerations

The size of the estate (and the nature of the assets) is another important consideration in this planning. For wealthy spouses (with assets in excess of $12-$15 million) who intend to benefit only each other (and no other beneficiaries), it might be better financially to leave assets in a Credit Shelter Trust rather than in a Marital Trust, particularly where the assets are likely to appreciate substantially (or where the expected time horizon of the Credit Shelter Trust is long, permitting years of growth).

The analysis will depend on a number of factors in the calculation, including the:

- surviving spouse's spending rate
- appreciation of the assets
- potential application of state estate tax (in those states that have their own estate tax systems)

On the other hand, for very wealthy spouses that are willing to make substantial lifetime gifts, it is probable that portability will produce the greatest tax savings. Why? Because the very wealthy surviving spouse could make a gift in trust promptly after his or her spouse's death, utilizing the deceased spouse's exemption amount, but structured in a manner that achieves income tax savings. Hence, it is important to consider many factors – and many assumptions – to attempt to determine the strategy that can produce the greatest transfer of wealth.

About the Attorney

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Harvard Muhm, Chair of the Trusts & Estates practice group, approaches his clients in a comprehensive way that transcends formulaic estate planning: Mr. Muhm is known for being independent-minded and an advocate for his clients. His knowledge of the law and experience with a wide variety of investment strategies enables him to bring his clients' advisors together to work as a team. This multi-disciplinary approach leverages opportunities and enhances the benefits to the clients.

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