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**AVOIDING OR REDUCING ESTATE TAXES
WITH A CREDIT SHELTER TRUST**

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If your total estate, including real estate, business interests, life insurance, retirement benefits, annuities, and the like, exceeds the federal estate tax threshold (currently \$3,500,000) (whether you are a single person or a married couple), or if it is approaching that amount, it is important for you to do some federal estate tax planning.

The Federal Estate Tax

In some ways, the federal estate tax is the "grand-daddy" of all taxes. In 2009, the federal estate tax is essentially a 45% tax on the value of your taxable estate over \$3,500,000.

We have counseled a number of clients who have estates valued at over \$3,500,000. Many are shocked to learn that up to half of their estate in excess of \$3,500,000 may be subject to a federal estate tax, which could mean a tax of hundreds of thousands of dollars!

It is important to know that Congress has given us several tools to use to reduce or even eliminate federal estate tax. When used properly, and when properly coordinated, the savings that can be achieved are remarkable. The tragedy is that many people have never done any federal estate tax planning.

How Large Is Your Estate?

Many of our clients have initially come to us assuming that the federal estate tax was not an issue for them, because their estate was too small. We find that most people are surprised by the size of their estates. This is largely due to appreciation that has occurred over the years in "silently appreciating" assets such as real estate and business interests, and as a result of overlooking "hidden assets" such as retirement, lump sum benefits, and particularly life

insurance. Unlike the Pennsylvania Inheritance Tax, which excludes from taxation certain assets such as life insurance, the federal estate tax is a tax on all property of a decedent, including all retirement benefits and all life insurance policies in which the decedent had an “incidents of ownership.” Thus, in determining the size of your estate for federal estate tax purposes, all assets must be carefully cataloged and valued, at their current market values.

Even if your estate is not currently \$3,500,000 or more, if it is even in the \$2,500,000 - \$3,500,000 range, we generally urge federal estate tax planning, due to the dual effects of inflation (which will continue to increase the size of your estate) and possible future tax legislation.

The Unified Credit

Every person is entitled to a so-called “unified credit” which can be applied against either federal gift taxes or federal estate taxes coming due as a result of gifts made during one's lifetime, or transfers made pursuant to one's Will or Trust after death. The “unified credit” used to be truly “unified”; a single credit amount applied to both lifetime gifts and gifts made at death. Now, that unified credit is really two different, but overlapping, credits—a credit to offset gift taxes on gifts in aggregate amounts of up to \$1,000,000 while you are living, and a different credit to offset gifts or transfers made at death in amounts up to \$3,500,000. However, if the credit is used to offset lifetime gifts, it is correspondingly reduced to offset gifts at death.

The trick, especially for married couples, is for each spouse to fully utilize his or her \$3,500,000 unified credit exemption, and not “lose” the benefit of the unified credit due to the unlimited marital deduction, described below.

The Unlimited Marital Deduction

Another tool that Congress has given us to reduce federal estate tax is known as the “unlimited marital deduction.” As a result of this deduction, a husband can transfer an unlimited amount of property to his wife, or the wife to the husband, either during their lifetime or after death through a Will or a Trust. The law does not impose a tax on this transfer from one spouse to the other, because Congress recognizes that using this device merely delays, but does not avoid, taxes. That is, the result of transfers from one spouse to the other is that the second spouse is left with a larger taxable estate, thus increasing the federal estate tax due at the second spouse's passing.

EXAMPLE: John and Sara Brown have total assets of \$7,000,000. Most of the assets are held jointly; some assets are in John's name alone. When John dies, he leaves everything to Sara. There is no estate tax on this transfer by John to Sara because of the unlimited marital deduction. However, when Sara subsequently dies, leaving an estate now in excess of \$7,000,000 to the children, only \$3,500,000 will escape federal estate tax, by virtue of Sara's unified credit. The remaining half will be taxed at the rate of 45%, for a total tax bill owed to

Uncle Sam of over \$1,225,000!

Note: This example reflects a fairly common scenario. In fact, the majority of couples having estates exceeding \$3,500,000 do not engage in any federal estate tax planning. As a result, typically one spouse leaves everything to the other spouse. The first spouse to die does not utilize his or her unified credit, because the entire transfer from the first spouse to the second spouse was covered by the unlimited marital deduction. Thus, only the second spouse utilizes their unified credit, with potentially devastating results.

John and Sara could have avoided this problem by taking advantage of each of their \$3,500,000 unified credits. The only practical way to achieve this, while leaving all assets available for use by both spouses during their lifetimes, is to create a Credit Shelter Trust described below.

The Credit Shelter Trust

The Credit Shelter Trust is a special tax saving trust designed to preserve the unified credit of the first spouse to die. Suppose that while they are alive, John and Sara Brown divide their \$7,000,000 estate so that each of them owns \$3,500,000 worth of assets (including life insurance proceeds) in their own names, or in their designated share of a Living Trust. When John dies, his \$3,500,000 share will be left, under the terms of his Will or his Trust, to his Credit Shelter Trust. The Credit Shelter Trust is designed so that the assets which are placed in it are always deemed to be the estate of the first spouse to die, thus utilizing and preserving that spouse's unified credit. Sara, the surviving spouse, is entitled to all the income from the Credit Shelter Trust, and even principal may be paid to Sara to meet such needs as support, maintenance, health or education. Then, when Sara dies, her remaining assets, up to \$3,500,000 held in her own name or in her Trust, will pass tax free to her beneficiaries of her choice. At the same time, John's Credit Shelter Trust will terminate, and whatever is left in that Credit Shelter Trust also passes to his beneficiaries tax free. As a result, the Brown's entire \$7,000,000 estate can be passed to their beneficiaries completely free of federal estate tax, and without reducing the financial security of the surviving spouse. In fact, the Credit Shelter Trust can actually enhance the financial security of the surviving spouse, because assets placed in the Credit Shelter Trust may be shielded from certain claims of creditors of the surviving spouse and can be effectively shielded from designing persons and the heirs of a second spouse in the event of remarriage.

The Qualified Terminable Interest Property (Q-Tip) Trust

In the example given above, the Brown's divided their \$7,000,000 estate into two separate shares, to be held either outright or in separate shares in the Living Trust. John's \$3,500,000 share was distributed at his death to his Credit Shelter Trust. But suppose John's share, either owned outright or in Trust, substantially exceeds \$3,500,000, and any one or more of the following is also true:

(1) This is John's second marriage, and he wants to leave assets to children of his first marriage;

(2) John is justifiably concerned about the financial management skills of his wife; or

(3) John is concerned about his wife remarrying at his death, then predeceasing her new husband, who might then claim the entire balance of the estate for himself and his children, effectively disinheriting John's children.

Under these circumstances, the Browns could consider a Q-Tip Trust. At John's death, he would leave the then current amount which can be sheltered by the unified credit (currently \$3,500,000) to a Credit Shelter Trust, and the balance of his estate to the Q-Tip Trust. Sara would be entitled to all the income from both the Credit Shelter Trust and the Q-Tip Trust, and, in addition, would have specified rights to the principal to both Trusts.

Under this arrangement, Sara's financial security would be assured, but John would also be assured that any assets not needed for Mary's welfare would be passed to his children, and the assets in the Credit Shelter Trust would be passed free of federal estate tax.

Set forth below is a chart showing the Tax Rates and Exemption Equivalents pertaining to the Federal Estate Tax as they are scheduled to vary over the next several years.

Tax Year	Maximum Tax Rate	Exemption Equivalent
2001	55%	\$750,000
2002	50%	\$1,000,000
2003	49%	\$1,000,000
2004	48%	\$1,500,000
2005	47%	\$1,500,000
2006	46%	\$2,000,000
2007	45%	\$2,000,000
2008	45%	\$2,000,000
2009	45%	\$3,500,000
2010*	N/A	N/A
2011	55%	\$1,000,000

*The 2001 Tax Law repeals the Federal Estate Tax for the year 2010 only.

Please contact us if you are interested in exploring these and potentially other methods for reducing or eliminating federal estate taxes in your estate.