By **David J. Correira**

Marital Deduction and Credit Shelter Planning

These strategies still have a place using a new paradigm

The increased federal exemption amounts for estate and gift taxes and the correspondingly larger number of individuals with assets below those amounts don't necessarily limit or eliminate the use of marital deductions and credit shelter trust (CST) planning. Instead, we may need a new paradigm that uses the marital deduction and CST more creatively. Many clients with assets between $1 million and $5 million will be increasingly eligible for a variety of creative tax planning techniques. Thus, practitioners need to identify unique opportunities based on a client's circumstances and the nuances of individual state rules. Advisors should also consider other issues, such as long-term care (LTC) planning, when formulating strategies for their clients.

With careful use of the federal marital deduction and CST, under current law, a married couple may individually pass assets worth $5.43 million or together pass assets worth $10.85 million free of federal estate tax. When you incorporate discount planning techniques (even as little as a 30 percent discount for minority interests and other factors), a couple may actually pass as much as $15 million tax free. Only a very small minority need many of the sophisticated tax planning techniques used for clients in past decades. Federal estate tax filings have dropped by nearly two thirds from roughly 90,000 to fewer than 30,000 annually, and not all of these filings require the payment of taxes; in fact, it's estimated that fewer than half of these returns have any liability whatsoever.[1]

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History of CST

A CST is an irrevocable trust that's typically used to pass assets down on a second parent's death and structured so a child won't have to pay estate taxes on assets over the estate tax exemption. For nearly 30 years, this trust has been a staple in estate tax planning. Today, given the high federal estate tax exemption, the estate tax is increasingly irrelevant to most Americans. And, the CST, along with the required health, education, maintenance and support distribution standard and/or mandatory income in the form of a qualified terminable interest trust (QTIP) may actually be detrimental to many couples and their families. Let's see why.

Popularized in the late 1980s and 1990s, various versions of the CST encouraged the use of the marital deduction and CST to minimize estate taxes. In some jurisdictions, just as is the case today, it was (and is) necessary to allow a state QTIP election over a portion of the CST to prevent the payment of state estate taxes on a first spouse's death. For example, let's consider a jurisdiction with a $1 million state exemption. Let's assume there's a CST funded at today's federal exemption levels of $5.43 million, of which a state QTIP election would be taken for $4.43 million. Trust income is paid to the surviving spouse, but the principal is discretionary (that is, it isn't distributed to the spouse). Assume the combined marital trust and CST hold $10.86 million; there's no appreciation or depreciation; and the surviving spouse has no other assets. On the second spouse's death, $5.43 million wouldn't be subject to federal and state estate tax; the family trust would be subject to state estate tax only for the portion of the CST subject to the state QTIP election (the $4.43 million). The balance of the family trust—$1 million—would pass free from federal or state estate tax.

In some instances, however, these types of trusts

cause problems. For example, for older clients needing nursing home care, the required broad distribution standard would make all trust assets technically available for the nursing home costs. This unfortunate result is particularly true for clients with estates in the $1 million to $5 million range.[2]

State Estate Tax

Most jurisdictions have eliminated their state estate tax or inheritance tax, but many haven't. State estate tax exemptions are often in the $1 million to $2 million dollar range.[3] Some jurisdictions (for example, Florida) limit their tax to the "pick up" or "sponge" (that is, a tax to the extent that the federal law allows a state credit so the net result is no tax—note that federal law eliminated this credit in 2005). Other jurisdictions have an estate tax limited to the pick up only, for instance Idaho. Other jurisdictions don't allow a state QTIP election, for instance the District of Columbia. Some states have an inheritance tax, which is a tax paid by beneficiaries and not the estate: Iowa, Kentucky, Nebraska, Pennsylvania and Tennessee. Others have both taxes but allow a credit for one over the other (for example, Maryland and New Jersey).[4]

> Your client can also use defective irrevocable trusts as an alternative to irrevocable life insurance trusts when he's not primarily concerned with estate tax avoidance.

These discrepancies make estate planning challenging. In a jurisdiction with no state QTIP election, it may make sense to minimally fund the CST at the state exemption level and allow for generous post-mortem planning use of disclaimers or disclaimer trusts by a surviving spouse. In such jurisdictions, incorporating a provision for a disclaimer trust may be worthwhile to allow the surviving spouse to push assets to the next generation and pay the state estate tax on that portion immediately.

In jurisdictions like Massachusetts and Rhode Island, which allow a state QTIP, a fully-funded CST up to the federal level with a state marital QTIP election for the amount above the state exemption might become a more regular planning technique.

In some instances, it might be preferable to create a testamentary CST by will, only allowing for post-mortem planning with one or two particular assets, creating a taxable estate for state purposes only. For example, practitioners may suggest that a young couple earning a high income obtain a large term insurance policy. (See "Estate and Inheritance Taxes Around the Country," p. 28, for those states charging estate and/or inheritance tax. Also, see "State Death Tax," on our website, *http://wealthmanagement.com/commentary/state-death-taxes-chart-2015,* for a more detailed summary.)

Example: Assume a young couple consists of one spouse with over $250,000 in income but with limited assets. The high earning spouse has a life insurance policy with a death value of $2 million to $5 million to pay for mortgages and college education in the event of his death. The couple's other assets are joint, including a $600,000 home subject to a $400,000 mortgage. The life insurance policy names as beneficiaries the surviving spouse and then the decedent's estate. The couple's will contains provisions that allow funding of a CST, if needed and desired, and each trust allows separate disclaimers or QTIP elections as appropriate so that the surviving spouse can make various choices post-mortem.

Leave to Surviving Spouse

Since portability of the federal estate tax exemption is permitted if timely secured by filing a federal estate tax return within nine months of the first death, another option is available: just leave everything to the surviving spouse. Although more often used in elder law planning, a purely discretionary testamentary trust for a surviving spouse with no ascertainable standard for distributions of income or principal is exempt from availability under federal Medicaid law. In theory, a decedent could leave over $5 million in such a trust, and the surviving spouse could qualify for medical assistance. In reality, a typical elderly client has under $1 million in assets and higher net worth clients typically self-fund or purchase LTC insurance. Yet, such a trust is attractive for clients who

haven't carefully planned, don't qualify for insurance and have over $1 million in assets, particularly if much of it's in real estate. The trick is guessing which spouse will die first, which is why this is usually a last minute plan for a terminal client with a not well spouse who's expected to survive.

Hybrid Trust

A new hybrid trust is attracting attention in some jurisdictions. This trust is designed to allow for transfers of assets to begin the disqualification period for LTC or Medicaid and take advantage of the CST." It's called a "doubly defective irrevocable income-only CST. It's irrevocable for purposes of public benefits transfers and is includible in an individual's estate as to income and at death because of its retained grantor trust provisions. Here's how it works:

First, the trust must comply with federal tax law as being a grantor trust and include various retained rights and powers, such as the right to income or the right to occupy premises. Second, it must comply with federal Social Security and Medicaid regulations under 42 U.S.C. Section 1396 and trigger a disqualification transfer under the Medicaid look-back and transfer rules. Third, it must address any particular state interpretations of its own trust law vis-à-vis the federal rules so as to not include a provision that would make the trust countable for Social Security or Medicaid. Finally, on the first spouse's death, the trust could elect funding of a CST. In a jurisdiction with a $1 million exemption, on the first spouse's death, the income-only trust splits in two to take advantage of the state exemption, passing estate tax free on the second spouse's death.

In the example above, there's no concern about the federal estate tax.

Defective Irrevocable Trust

Your client can use a defective irrevocable trust to allow for an immediate Medicaid transfer and for future gifting. For example, assume you have a client with a $1.5 million estate who anticipates future gifts to his children and grandchildren, but he doesn't want to make the gifts now. However, he wants to start a Medicaid transfer. Perhaps, he anticipates self-funding a nursing home or at-home care up to a certain level, but he doesn't want to risk complete depletion of his estate. The $1.5 million estate could be split into three trusts: (1) a simple revocable trust, funding the reserve with cash and other liquid assets; (2) an irrevocable trust with an occupancy interest, holding the principal residence and/or a second home; and (3) the balance in an irrevocable income trust with retained powers, allowing distributions among a class of beneficiaries, children and grandchildren. This set-up would allow your client to make gifts for years, if not decades, to fund college and weddings.

In such trusts, some advisors suggest retaining a limited power of appointment over a class of beneficiaries. However, because there can be drafting errors with such provisions, and as some states challenge a number of retained powers (particularly if not drafted well), many advisors warn against their use.[5]

> With the high federal exemption, estate tax planning becomes very simple for a Florida client.

Your client can also use defective irrevocable trusts as an alternative to irrevocable life insurance trusts (ILITs) when he's not primarily concerned with estate tax avoidance. If an older client has some life insurance that he expects to keep and if, on his death, it will be paid to an ill spouse needing nursing home care, all the proceeds will be considered available by state regulators for LTC. However, if it's transferred to a defective income-only trust, a certain amount of funds could supplement the care of the spouse but principal would be protected from payment toward LTC. Alternatively, the life insurance could be left to the estate, and the creation of a testamentary discretionary trust for the surviving spouse would be exempt for purposes of LTC qualification.

These trusts can be helpful when planning errors were made, for instance, when transferring real estate to children. It's common in many jurisdictions to find lawyers transferring the principal residence to children or other heirs subject to a life estate. Often, the purpose is the transfer of a middle class client's primary asset without probate and/or to attempt some or full

Estate and Inheritance Taxes Around the Country

Here's an overview for 2015

State has estate tax: exemption amount noted
State has inheritance tax
State has estate tax and inheritance tax

WA $2.054M
OR $1.0M
MN $1.4M
IL $4.0M
NY $3.125M
VT: $2.75M
ME $2.0M
MA: $1.0M
RI: $1.5M
CT: $2.0M
NJ: $.675M
DE: $5.43M
MD: $1.5M
DC: $1.0M
HI: $5.43M
NE
IA
KY
TE
PA

Notes:

1. This map doesn't address pending legislation or increasing threshold levels after 2015; a number of states have phased in increases, such as New York and Maryland, which reach the federal level in 2019.
2. The state estate tax rates generally range from 1 percent to 16 percent; some states are higher, and some state provisions are too complicated for a simple chart.
3. Many of the states not coded have the "sponge tax" tied to the federal credit, which was eliminated in 2005; this means that such states could reinstate their estate tax if federal changes in the future allow it; this doesn't include Arizona, Kansas, North Carolina and Ohio, which have eliminated all forms of death tax and any statutory triggers tied to a reinstated federal credit.
4. Oregon has a $1 million per person estate tax exemption and a top rate of 16 percent for estates in excess of $9.5 million. In 2015, Washington has a $2.054 million exemption and a top marginal rate of 20 percent for estates above $9 million.
5. The inheritance tax states have no consistent format for comparisons on this map.

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inaccessibility for LTC. But, this type of transfer can result in a disadvantage. If the property is sold while the client is in a nursing home, part of the real estate would belong to the heirs at its original basis, which would generate capital gains taxes on a sale; and part would belong to the client in the form of the actuarial value of the life estate, a share subject to the principal residence exclusion under Internal Revenue Code Section 121 but unprotected from counting towards LTC. You can correct all these outcomes with a transfer by all of the owners into a defective trust with or without a correction to the parents first and with or without income only provisions. In addition, a step-up in tax basis at death often outweighs the benefit of any estate tax savings with an elimination of capital gains taxes on real estate or investments.

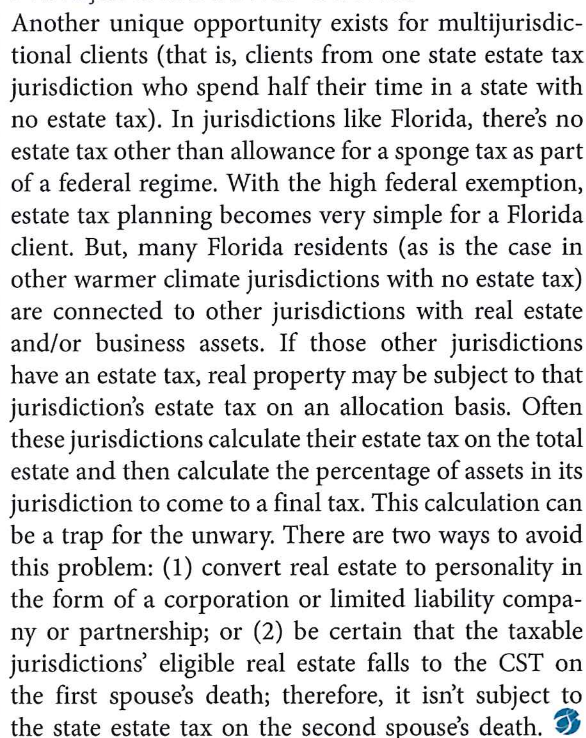
Some clients may opt to split their estates among several defective irrevocable trusts using state exemptions as well. A couple may decide to create separate defective income-only trusts and a joint revocable trust. The advantages are the same as created by a joint defective irrevocable trust, which splits on the first death using applicable state estate tax exemptions.

In second or third marriages, when spouses use prenuptial agreements to allow some estate planning between them, many planners take advantage of using the estate tax exemption of the less well-off spouse in exchange for providing income-only provisions for the surviving spouse. This same option is available to smaller estates when a state estate tax exists, using the defective irrevocable income only trust and gaining tax savings and nursing home protection while not risking the entire trust to being available under a health, education and maintenance distribution standard.

SPOT LIGHT **Class Act**

"The Café Royal" (12 in. by 8 in.) by Charles Ginner, sold for $107,819 at Christie's Modern British and Irish Art Day Sale in London on June 26, 2015. Ginner is most famous for his paintings of central London scenes.

Multijurisdictional Clients



Another unique opportunity exists for multijurisdictional clients (that is, clients from one state estate tax jurisdiction who spend half their time in a state with no estate tax). In jurisdictions like Florida, there's no estate tax other than allowance for a sponge tax as part of a federal regime. With the high federal exemption, estate tax planning becomes very simple for a Florida client. But, many Florida residents (as is the case in other warmer climate jurisdictions with no estate tax) are connected to other jurisdictions with real estate and/or business assets. If those other jurisdictions have an estate tax, real property may be subject to that jurisdiction's estate tax on an allocation basis. Often these jurisdictions calculate their estate tax on the total estate and then calculate the percentage of assets in its jurisdiction to come to a final tax. This calculation can be a trap for the unwary. There are two ways to avoid this problem: (1) convert real estate to personality in the form of a corporation or limited liability company or partnership; or (2) be certain that the taxable jurisdictions' eligible real estate falls to the CST on the first spouse's death; therefore, it isn't subject to the state estate tax on the second spouse's death.

Endnotes

1. Internal Revenue Service Federal Income Statistics Data, *IRS.gov*.
2. 42 U.S.C. 1396, HCFA Transmittal 64.
3. Connecticut, $2 million; the District of Columbia, $1 million; Delaware and Hawaii, $5.43 million; Illinois, $4 million; Maine, $2 million; Maryland, $1.5 million; Massachusetts, $1 million; Minnesota, $1.4 million; New Jersey, $675,000; New York, $3.125 million; Oregon, $1 million; Rhode Island, $1.5 million; Vermont, $2.75 million; and Washington, $2.054 million. State Estate Inheritance Rates & Exemptions for 2015, *TaxFoundation.org*, State Death Taxes, *TaxPolicyCenter.org*, State Summary of Death Taxes, *MaguireWoods.com* (April 15, 2015).
4. *Ibid.*
5. Internal Revenue Code Sections 671-678.