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Rethink the Credit-Shelter Trust

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The recent American Taxpayer Relief Act of 2012 increase in the income tax rates and creation of the new 3.8% investment (Medicare) tax can be costly for a typical estate planning credit-shelter trust, absent a rethinking about its design.

A credit-shelter trust (sometimes called a by-pass trust) is a longstanding staple in most estate planning documents. Its function is to hold the first deceased spouse's estate exemption amount in trust after the first spouse's death so that the trust assets and any appreciation are not later included in the surviving spouse's estate for estate tax purposes.

The following two income tax issues are now relevant for credit-shelter trusts:

Need for a Second Stepped-Up Basis. One, historically credit-shelter trust assets have been stepped-up only once when the first spouse dies. The assets are not stepped-up when the surviving spouse dies. The new income tax rates and 3.8% investment tax shed new light on estate planning options that can provide *also* a stepped-up basis for these assets when the surviving spouse dies. This can save considerable income tax.

Trust Income Taxes. Two, this threat of increased income taxes (and 3.8% tax) will affect a credit-shelter trust to the extent the trust income is taxable to the trust and not carried out as distributable net income (DNI) to the beneficiaries. The highest marginal income tax rate kicks in at trust taxable income of $11,650.

Most credit-shelter trusts carry out only ordinary income as DNI, but not capital gains. This results in credit-shelter trusts being taxable on the capital gains regardless of the DNI distributions. *See generally* Treas. Reg. § 1.643(a)-3 dealing with when capital gains can be included in DNI.

Potential Responses to the Above Income Tax Threats:

(1) **Do nothing?** Existing credit-shelter trusts for many clients (prior to the recent tax legislation) will still do the job for estate tax planning purposes by segregating the estate exemption amount for the first spouse's estate. However, these existing credit-shelter trusts likely do nothing for reducing the above income tax exposure.

(2) **All Outright to the Surviving Spouse?** With portability of a first deceased spouse's estate exemption, some clients may end up opting for the simplest solution of having the first spouse's estate pass outright to the surviving spouse without use of a credit-shelter trust.

This, no doubt, solves the above income tax exposure.

However, portability does nothing to protect appreciation of the first spouse's assets from estate tax later at the surviving spouse's death.

This outright option also loses the essential non-tax benefits of a trust, such as asset protection, and assuring the trust property does not end up with another remarried spouse, etc.

(3) **Include Capital Gains in DNI?** This is a redesign of the credit-shelter trust so that capital gains can be carried out as DNI. This is a partial cure in that it works only if the distributions to the beneficiaries are large enough to carry out ordinary income and capital gains.

However, the trust's distribution of the capital gains merely to obtain this income tax advantage may unnecessarily increase the beneficiary's own assets and reduce the exemption effect of the credit-shelter trust. This approach also does not address the above need for a second step-up in basis of the assets at the surviving spouse's death.

(4) **Defective Trust Status for the Credit-Shelter Trust.** Redesigning the credit-shelter trust so that it will be defective for income tax purposes as to the surviving spouse is the optimal remedy.

An effective approach is to include defective income trust elements similar to what was coined back in 2006 as a "Supercharged Credit Shelter Trust". [1]

With this design the credit-shelter begins as an inter-vivos QTIP trust that each or both spouses create while they are alive. It serves as the primary estate planning document for each spouse. I, as an aside, am a longtime fan of inter-vivos QTIP trusts.

This QTIP trust becomes the credit-shelter trust after the first spouse's death. It then continues as a defective credit-shelter trust as to the surviving spouse.

From a technical perspective, the supercharged QTIP trust essentially replaces the DNI regime with the defective trust features. The trust is not treated as a separate taxpayer for income tax purposes nor for the 3.8% tax. The surviving spouse as the taxpayer of this income (rather than being taxable to the trust) in many cases can result in worthwhile income tax savings.

This supercharged trust also eliminates the necessity of having to file a separate trust income tax return. Instead, all trust income, losses, deductions, etc., are reportable on the surviving spouse's personal income tax return Form 1040. Prior to the death of the first spouse, these items are reportable on both spouses' Form 1040.

[1] This name is a registered servicemark by well-known estate planning lawyers Mitchell M. Gans and Jonathan G. Blattmachr.

As to getting a second stepped-up basis when the surviving spouse dies, this supercharged credit-shelter trust gives the surviving spouse the ability during his lifetime to exchange assets with the credit-shelter trust by substituting low basis assets for higher basis assets.

This substitution will not result in a taxable exchange for income tax purposes, as otherwise is the case with a non-defective credit-shelter trust.

The surviving spouse can thereafter hold the lower basis assets in his own name with those assets getting a stepped-up basis at his death. Otherwise, without the defective trust status the lower basis assets remain in the credit-shelter trust without the potential for this stepped-up basis.

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