CHAPTER 29

Using Credit Shelter and Marital Trusts to Reduce Estate Taxes

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If you are married and your combined estate with your spouse exceeds the amount exempt from estate taxes, you will need to incorporate estate tax reduction strategies into your estate plan. The most common technique used by married couples to reduce their estate tax bill and pass more on to their beneficiaries is the use of a Credit Shelter Trust, also referred to as a Bypass or Family Trust, coupled with a Marital Trust, also referred to as a Marital Deduction Trust or QTIP Trust.

The amount exempt from federal estate taxes is $2 million in 2008, $3.5 million in 2009, unlimited in 2010, and unless the law is changed, $1 million in 2011 and thereafter (indexed for inflation).

Aside from the federal estate tax, many states impose their own separate estate tax, so even if your estate is not taxable at the federal level, it may very well be taxable at the state level. Thus, proper estate tax planning is crucial to insure your beneficiaries receive the maximum amount possible. (Because many states that collect their own estate tax have an exemption that is "decoupled" from the federal exemption, this chapter will focus on the federal estate tax and how to minimize it. For those who live in a state with its own estate tax, you will need to consult with an attorney in your state to insure the effective use of both your state and federal exemptions.)

If you do not incorporate the Credit Shelter/Marital Trust strategy into your estate plan, you and your spouse will end up wasting the estate tax exemption of one spouse. Here is why: while spouses can leave any amount to each other at death free from estate taxes (as long as the surviving spouse is a U.S. citizen — the rules are very different for non-citizen spouses), if it all goes outright and free from estate taxes at the first death, there will be no need to use the deceased spouse's exemption. However, later, when the surviving spouse dies, he or she will only have his or her own estate tax exemption left.

However, by using the Credit Shelter/Marital Trust strategy in your estate plan, you and your spouse can leave two times the amount of the estate tax exemption to your heirs before any estate taxes will be imposed. Here is how:

1. **Incorporate Credit Shelter and Marital Trusts into Your Estate Plan.** This can be done in your Last Will and Testament or Revocable Living Trust. (See illustrated examples below.)

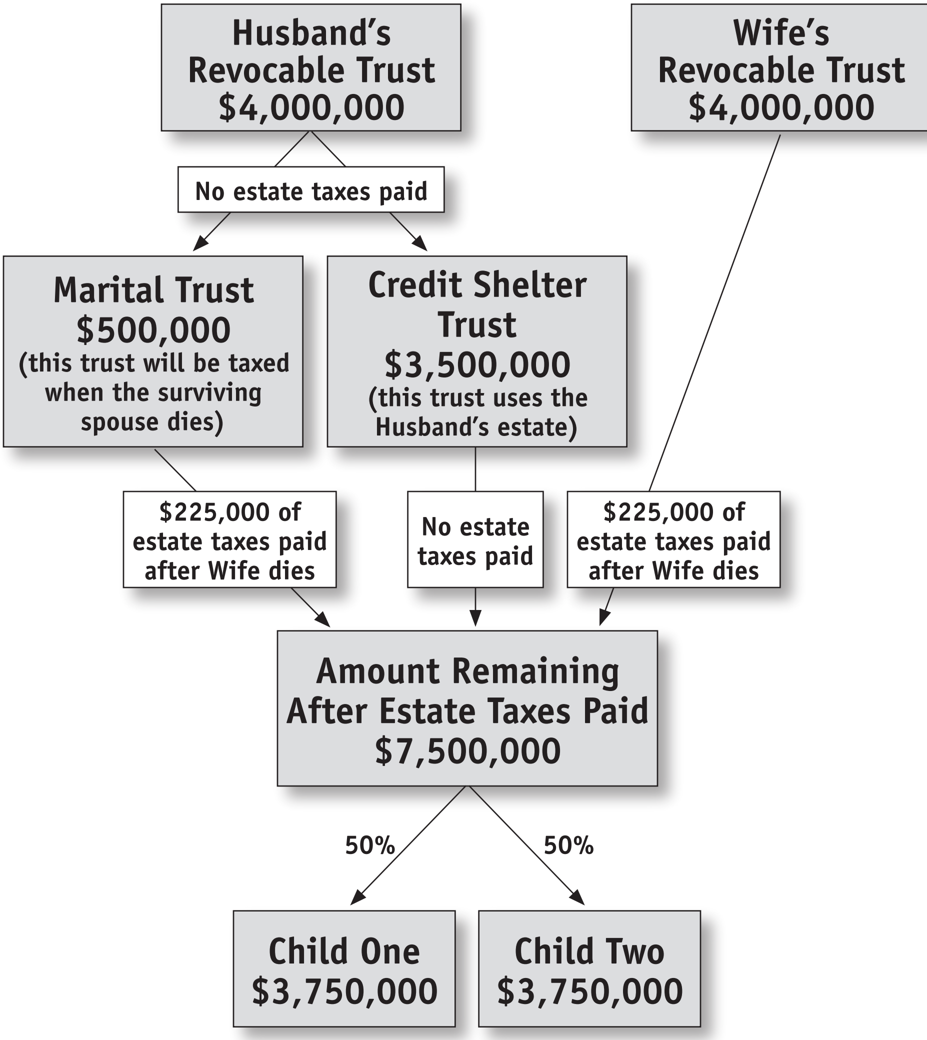
2. **Divide Your Assets.** In non-community property states, you will need to divide your assets so you and your spouse have approximately an equal amount in your individual names (or in the names of your trusts). This is an important step that is often overlooked. If your assets remain jointly titled, then the Credit Shelter and Marital Trusts cannot be funded because the joint assets will pass by right of survivorship instead of under the terms of the deceased spouse's will or trust.

3. **Upon the First Spouse's Death, Fund the Credit Shelter and Marital Trusts.** The amount funded into each trust will depend upon the year of death. For example, if the death occurs in 2009, then the first $3.5 million of the deceased spouse's assets will be placed in the Credit Shelter Trust, and the excess (if any) will be placed in the Marital Trust. The Credit Shelter Trust can provide for the needs of the surviving spouse as well as your children or other beneficiaries, but it must include certain restrictions so that the balance of the trust will not be included in the surviving spouse's estate when he or she later dies. The Marital Trust can only be used for the benefit of the surviving spouse and all the trust income must be distributed to the surviving spouse.

4. **Upon the Surviving Spouse's Death, Use His/Her Estate Tax Exemption.** When the surviving spouse later dies, he or she will still have his or her own estate tax exemption, so his or her assets, valued up to the exemption amount, will pass to available heirs free from estate taxes. Anything over the exemption amount is taxed, as well as anything remaining in the Marital Trust.

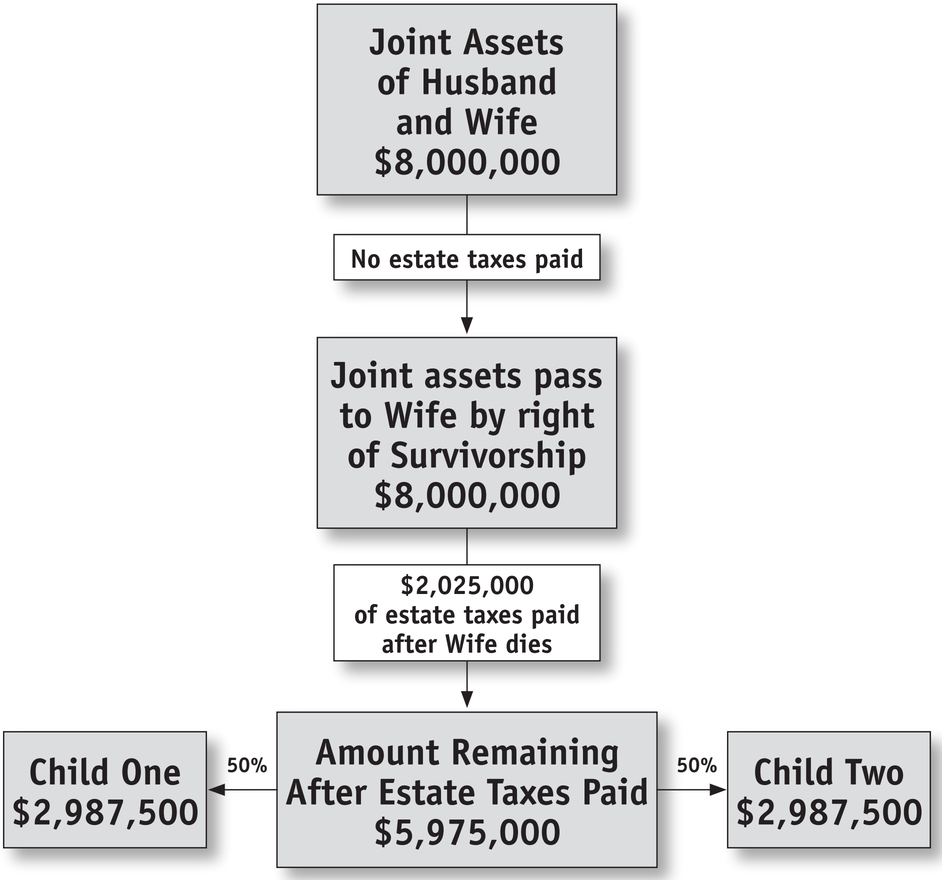
5. **Pass Assets Remaining in the Credit Shelter Trust Estate Tax Free.** Whatever remains in the Credit Shelter Trust when the surviving spouse dies will pass estate tax free to your heirs.

   EXAMPLE (Credit Shelter/Marital Trust Planning): Assume you are married and have two children, your combined estate with your spouse is valued at $8 million, and your estate plan includes two Revocable Living Trusts that incorporate Credit Shelter/Marital Trust planning. Assume your husband dies in 2009 when the federal estate tax exemption is $3.5 million, and then you later die in a year when the federal estate tax exemption is also $3.5 million and the estate tax rate is 45%.



In this example, while your combined estate is valued at $8 million, both your federal exemptions are effectively used so that only $1 million of your estate is subject to estate tax. After paying $450,000 in estate taxes, $7.5 million passes to your children. Compare this with an estate plan without any Credit Shelter/Marital Trust planning.

> **EXAMPLE (No Credit Shelter/Marital Trust Planning):** Assume you are married and have two children. Your combined estate with your spouse is valued at $8 million and all assets are jointly titled. Assume your husband dies in 2009 when the federal estate tax exemption is $3.5 million, and then you later die in a year when the federal estate tax exemption is also $3.5 million and the estate tax rate is 45%.



These examples illustrate the powerful benefits of the Credit Shelter/Marital Trust estate tax planning strategy: Without Credit Shelter/Marital Trust planning, your children will pay $2,025,000 in estate taxes before receiving their inheritance. The choice of the difference of $1,525,000 going to your children or to the IRS is yours to make.

What you should do: Consult with a qualified estate planning attorney in your area to learn if your state has its own estate tax and how you can effectively use both your federal, and, if applicable, state estate tax exemptions to leave more to your heirs after you die.

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