

## Estate Tax and Your Disclaimer Credit Shelter Trust

Current tax law concerning estate taxes provides an exemption equivalent of \$1,500,000 per person. Each of you can give away during life or at death a combined total of \$1,500,000, without any gift or estate taxes being due. Congress has gradually increased the exemption equivalent amount over time, and it will continue to increase as follow:

Year	Exemption
2005	\$1,500,000
2006	\$2,000,000
2007	\$2,000,000
2008	\$2,000,000
2009	\$3,500,000
2010	<i>no tax</i>
2011 and out	\$1,500,000

Additionally, current tax law provides for an unlimited marital deduction for property inherited by a United States citizen spouse (a non-citizen had NO marital deduction). This means that you may transfer an unlimited amount of property to your spouse without incurring any federal gift or estate tax at all. If at the death of the first spouse all property goes to the surviving spouse, there is no estate tax in the first estate because of the unlimited marital deduction.

However, the tax problem occurs in the *second estate*. When the surviving spouse dies owning all of the family assets, he or she has *only the one* \$1,500,000 exemption. Anything in this second estate over \$1,500,000 will be taxed at a rate that begins at 43%. If you give everything to your surviving spouse, your \$1,500,000 exemption equivalent is wasted. This is usually described as the "Second Step" problem, as it gives rise to taxes in the survivor's estate.

Good estate tax planning involves utilizing as fully as possible each spouse's \$1,500,000 exemption equivalent, so as to pass up to \$3,000,000 estate tax free to your children, rather than just \$1,500,000 from the surviving spouse. To accomplish this, when the first spouse dies, rather than giving everything to your surviving spouse outright, you put up to \$1,500,000 in trust (usually called a "credit shelter" trust). The surviving spouse can serve as trustee of this trust and receive all of the trust income, and receive principal if necessary for his or her support and medical care. Extreme care must be taken in drafting the trust if the surviving spouse is to be the trustee, as a mistake can lose the credit shelter aspect. When your surviving spouse dies, however, the trust assets are not part of his/her estate. In this way you can pass up to \$3,000,000 estate tax free to your children (\$1,500,000 through the estate of the second spouse to die because of his/her exemption, and the \$1,500,000, or whatever it has appreciated to, in the credit shelter trust created by the first spouse to die ). It is important to shield up to \$1,500,000 in the first estate by not allowing it to pass to the surviving spouse outright.

This can be done by simply creating a credit shelter trust upon the first estate, and funding it with the maximum amount left of the credit equivalent amount (currently up to \$1,500,000). This allows for no discretion, and just places the amount in the credit shelter. The other choice is to give the option to the surviving spouse to fund the credit shelter trust.

Your will and testamentary trust leaves the entire estate *outright* to the survivor. The Credit Shelter Trust is to be funded by the surviving spouse *disclaiming, or rejecting*, part of the estate. This enables the survivor to decide how much to keep outright (and to be taxed in the second estate), and the amount to continue in trust shielded from any further estate tax. There is a 9-month period after the first death in which the survivor may disclaim or reject all or part of his or her inheritance. Most assets can be disclaimed, including life insurance, but there are strict rules. The survivor *can not* accept, collect or exert control over an asset and *then* disclaim it – further, joint accounts with the right of survivorship between spouses, and some other types of joint property may create special problems. The Internal Revenue Service will recognize a disclaimer of property that passes by operation of law, such as joint accounts with the right of survivorship, however many state property laws do not. To make sure that a disclaimer will be effective for joint property you should seek the advice of an attorney in that state, or divide (split) your assets to make sure. The special nature of Florida homestead property can also cause major problems if the value is high.

While this type of "Disclaimer Trust" provides discretion, if the survivor *fails to disclaim there will be no estate tax savings*. You must consider this, as there may be a great reluctance on the part of the spouse to "give up" anything such a short time after an emotional loss. Think this over carefully, and decide as to whether you wish the disclaimer, or to just use the mandatory funding of the Credit Shelter Trust.

In order to take advantage of the estate tax planning provisions of the credit shelter trusts and ensure maximum utilization of your \$1,500,000 exemptions, and avoid the problems of disclaiming joint property discussed above, *you should split your assets*, so that each of you will have property worth approximately one half the total, in your names alone so it can pass pursuant to your wills into your credit shelter trust. You must change some of your beneficiary designations. The key to the tax savings is to force a taxable estate when the first spouse dies, and then use the \$1,500,000 exempt amount. Remember that property held jointly with the right of survivorship passes automatically to the surviving joint tenant and is not controlled by your will, although it may be disclaimed. You must also take into account your present SGLI and other life insurance beneficiary designations; these most probably have to be changed.

The following list will cover important points of awareness regarding some changes that must be made, however check each specific items with your attorney:

#### **Bank Accounts, Credit Unions, Certificates of Deposit.**

Should not be held in joint names with the right of survivorship, as the other spouse most probably cannot make an effective disclaimer. They should be titled in one spouse's name alone, so they will go into the probate estate. If the surviving spouse disclaims, the CD then passes under the will to the credit shelter trust.

#### **Beneficiary Designations.**

In the case of IRAs and retirement plans, the Spouse, if living, should be the beneficiary. Only the surviving spouse can elect to postpone distribution (and taxation) for a longer period of time, by "rolling-over" into their own Plan or IRA.

In the case of life insurance, whether SGLI or commercial, all or part of the proceeds can be disclaimed, and therefore diverted to the credit shelter trust. This will most likely require a change of beneficiary. The contingent beneficiary typically should be:

**“The trustee of the credit shelter trust in my last will and testament”**

You cannot have another *person* as the contingent or alternate beneficiary, because when your spouse disclaims it is as if he/she died *before you*, and the amount disclaimed will go to the contingent beneficiary.

**Stock, Mutual Funds, etc.**

If you own stock, mutual funds, etc., they should be in one name, not joint with the right of survivorship.

**Real Estate.**

Real Estate enjoys a special type of ownership when owned by a married couple, called “tenants by the entirety”. One of the important aspects of this type of ownership is that the property is usually protected from the claims of creditors of only one of the spouses. Because of this, and due to the complexity of **Homestead** in Florida and several other states, it may *not* be advantageous to transfer your residence. This should be discussed with your attorney. Remember, not all the assets must be subject to the disclaimer, just enough to make up the \$1,500,000, or to achieve the tax savings that you wish.

**Business and Certain Investment interests.**

**Sole Proprietorships** will be available to the disclaimer as they are all in one name.

**Certificates of Limited Partnership** should be examined to make sure they are not joint with the right of survivorship.

**General Partnership** interests can be disclaimed. If there is a Buy-Sell Agreement, it must be reviewed for any prohibition against this type of transfer.

**Close Corporation Stock** must be changed into one name, again not joint with the right of survivorship.

**Personal Property.**

Furniture, furnishings, clothing, jewelry and items that have no certificate of ownership will pass in the estate of the spouse that owns those items.

This is only a general discussion of *some* aspects of enabling the funding of the credit shelter trust, and as you can see, if your investments and assets are complex, the

funding or transfer process can be involved, time consuming and costly. The funding requirement does not cease after you initially re-title the assets, but continues during your lifetime. Every time you sell an asset, purchase a new asset, or change brokers it will result in funding considerations and maintaining a balance between both spouses.

The alternative to the division of assets and the use of credit shelter trusts would be to attempt to keep your *combined* estates under \$1,500,000.00 by establishing a vigorous gifting program. You would continue to gift away all sums over \$1,500,000, but not exceed the annual exempt gift amount.

During your life, you may give \$11,000 (\$22,000 in the case of a married couple) annually to anyone without incurring any gift tax.. For example, if you have 2 children and 4 grandchildren, then you could conceivably give \$22,000 to **each** every year (or \$132,000) without a gift tax. A significant tax benefit of such a lifetime gift is that appreciation in value following the date of the gift is not subject to transfer taxes. By giving property likely to appreciate in value, you remove from your estate the increase in value, thereby avoiding any transfer tax on that appreciation. However, bear in mind that the recipient takes your cost or basis in the gifted property, and will have to pay any capital gains tax using that cost upon a sale of the property, whereas if the recipient inherited the asset, the basis would be the value at date of death, eliminating any gain from your purchase to your death.

If you make taxable gifts during your lifetime (e.g., gifts of more than \$11,000 to any individual in any one year or more than \$22,000 to one individual if your spouse joins in the gift), there will be a gift tax due which may reduce **your \$1,500,000 exemption**. If you have a lower exemption equivalent then the estate tax will apply at a lower level.