The Use of the Credit Shelter Trust in the Time of Portability

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The credit shelter trust has been a widely used tax savings tool for estates that exceed the exclusion amount. However, the use of credit shelter trusts has grown out of favor ever since the U.S. Congress amended the Internal Revenue Code to allow for the portability of a spouse's unused exclusion amount. This discussion analyzes the continued use of a credit shelter trust in conjunction with the unlimited marital deduction in order to achieve estate tax savings for estates that hold appreciating assets.

Introduction

Historically, any unified transfer tax credits not used on the estate tax return were lost and could not be used by another taxpayer. In 2010, the U.S. Congress amended Internal Revenue Code Section 2010 to provide to the surviving spouse a unified credit equal to the tax on his or her basic exclusion amount as well as any unused exclusion amount of a deceased spouse.

Referred to as "portability," this provision seemingly nullified the utility of the credit shelter trust, a tool of tax planners to make use of any remaining wealth transfer tax credits on the decedent's estate tax return.

This discussion explores the continued utility of the credit shelter trust and illustrates circumstances where large estates can pay less in estate tax by using the credit shelter trust than they would pay by making the portability election.

Background of the Marital Deduction

Section 2056 provides a deduction from the gross estate for property that passes to the surviving spouse of the decedent. Known as the unlimited marital deduction, this provision provides for a deferral of wealth transfer tax on the property left to the surviving spouse until his or her death, at which time any remaining property is presumably included in the surviving spouse's gross estate.

Depending on how long the surviving spouse lives after the decedent's passing, the benefits of the deferral can be quite significant for larger estates.

The following example illustrates the economic benefit associated with the marital deduction.

Joan dies with a gross estate of $25 million, leaving it all to her spouse Tracy. Joan's estate pays no estate tax by taking a marital deduction, which reduces her taxable estate to zero.

If Tracy were to live another 20 years, she would enjoy the use of the entire $25 million left to her by Joan for that period. If there were no marital deduction, Tracy would receive less than the full $25 million at Joan's death because tax would be due from Joan's estate.

Assuming a 40 percent flat unified rate, no remaining unified credit, and no marital deduction, our simple example would yield Tracy only $15 million in a net bequest from Joan after the $10 million ($25 million estate × 40 percent tax rate) in estate tax is paid.

Therefore, the marital deduction provides the surviving spouse Tracy with the use of the $10

million in tax that would otherwise be payable to Treasury upon Joan's passing.

In this example, Tracy will ultimately pay tax on the property Joan left her; however, it will be at a later date. Therefore, the marital deduction is not an exclusion—but rather a deferral of tax on the property passed to a surviving spouse.

Through this deferral, the surviving spouse gets use of the wealth transfer taxes over her lifetime in what has often been described as an interest-free loan from the government.

Perhaps the term "unlimited" marital deduction is a misnomer. While a decedent may leave as much property outright to his or her spouse free of wealth transfer tax, limitations generally do apply when the property is of a terminable interest.

Terminable Interest Property

An exception to the marital deduction is the terminable interest rule found at Internal Revenue Code Section 2056(b). Under this rule, a marital deduction is denied for property in the form of a terminable interest left to a surviving spouse.

A terminable interest is defined as an interest in property that will cease upon the passage of time or on the occurrence or an event.[1]

Terminable interests include a life estate or a term of years.[2] Under the general rules defining the gross estate,[3] a terminable interest originating with the decedent would generally not be included in the surviving spouse's gross estate, unless the surviving spouse had a general power of appointment over the property.[4]

An exception for the terminable interest rule is found at Section 2056(b)(7) for "qualified terminable interest property" ("QTIP").

By election, the decedent's estate may take a marital deduction for certain terminable interests that pass to the surviving spouse in exchange for the inclusion of the entire value of the property in the surviving spouse's gross estate.[5]

Additionally, should the surviving spouse give away the qualifying interest during life, Section 2519 will treat the disposition as a constructive transfer by the surviving spouse of all the interest in the property other than the income interest, and gift tax implications will follow accordingly.

The QTIP must be a qualifying income interest for life. Specifically, the surviving spouse must be entitled to all of the income from the transferred property for life and such income must be payable at least annually.

In addition, no person may hold the power to appoint any portion of the property to anyone but the surviving spouse.

Placing property in trust and making a QTIP election:

1. permits the decedent some measure of control over the property after death and
2. provides a deferral of estate tax through a marital deduction.

That is, it provides the decedent the ability to take care of his or her surviving spouse while dictating the ultimate disposition of the property.

For example, let's now assume that Tracy is Joan's second spouse and that Joan had children from her first marriage. By giving property outright to Tracy in her will, Joan cannot ensure that her children will be taken care of after Tracy's passing.

This is because Tracy can do whatever she wants with the property bequeathed to her outright. Realizing this may not be the best result, Joan can place her property in a QTIP trust to Tracy for life and the remainder to her children upon Tracy's death.

By virtue of the election, Joan's estate takes a marital deduction and defers tax on the transfer of wealth. In addition, Joan gets to take care of her spouse and children.

The Credit Shelter Trust

As its name implies, the credit shelter trust is designed to utilize the remaining unified credit of a decedent through the use of a trust. A decedent establishes a trust and designates an amount of property equal to the remaining applicable exemption be passed to the trust.

If the decedent wishes for his or her surviving spouse to have access to the property in trust, the trust can be established with terms that do not qualify for a QTIP election.

By doing so, the decedent's estate cannot take a marital deduction for the property passing to the credit shelter trust and thus, the property is subject to estate tax. That estate tax will be reduced by the decedent's remaining unified credit.

Let's now assume Joan in our example has an estate of $25 million and has enough unified credit to cover the estate tax on $5 million of property transferred. In her will, Joan sets up a credit shelter trust and directs her administrator to transfer $5 million to it.

The credit shelter trust provides the trustee with the power to use the property for the benefit

of Tracy in certain circumstances. The residuary of Joan's estate then passes to Tracy under the will through a QTIP trust.

As a result of the credit shelter trust, Joan's taxable estate of $5 million after her $20 million marital deduction pays no estate tax due to her remaining unified credit.

Tracy gets access to all of Joan's property if needed, Joan's estate pays no estate tax, and Joan uses all of her available unified credit.

Portability

Every estate is entitled to a unified credit against estate tax.[6] For 2020, this credit equals the estate tax due on a taxable estate of $11.58 million.

This figure, technically termed the basic exclusion amount, is varyingly referred to as the applicable exemption or the applicable exclusion. It is indexed for inflation from 2010 on an initial amount of $10 million.[7]

For deaths in 2010 and after, a surviving spouse may use any unused exclusion of his or her deceased spouse, technically termed the deceased spousal unused exclusion amount ("DSUE"), provided the surviving spouse has not remarried.[8]

Returning to the original facts in our example, had Joan left her entire estate outright to Tracy and used none of her unified credit, Tracy would be able to use a credit equal to the tax on her basic exclusion amount—as well as Joan's unused basic exclusion amount.

It is worth noting that while Tracy's basic exclusion continues to increase annually with the inflation adjustments provided under Section 2010, the value of Joan's unused exclusion is locked at the amount applicable in her year of death.

The portability of the unused exemption of a decedent to his or her surviving spouse would appear to eliminate the utility of the credit shelter trust. However, as the following example illustrates, for estates above the exclusion amount with appreciating property, that may not be the case.

Joan has a gross estate of $25 million. Neither she nor Tracy make any lifetime gifts. To simplify the calculations, let's assume the following:

1. The basic exclusion amount is $10 million in Joan's year of death and increases $500,000 per year.
2. The estate tax is a flat 40 percent.

Let's also assume that Tracy owns no other property and the value of QTIP property remains at $25 million during her life.

In the current year, Joan passes away and leaves her entire estate in a QTIP trust to her spouse Tracy with the remainder to be paid to Joan's children from her first marriage upon Tracy's death. As a result, Joan's estate will pay no estate tax.

Upon Tracy's death 20 years later, she will include in her gross estate the property in the QTIP trust. However, Tracy will have Joan's unused exemption of $10 million in addition to her own exemption of $20 million at the time of her death. Joan and Tracy collectively pay no estate tax.

Without a Credit Shelter Trust
A Constant Estate Value Example
Joan's Form 706

Gross Estate	$ 25,000,000
Marital Deduction	(25,000,000)
Taxable Estate	0
Tax (40%)	0
Section 2010 Credit	(4,000,000)
Tax Due	$ 0

Without a Credit Shelter Trust
A Constant Estate Value Example
Tracy's Form 706

Gross Estate	$ 25,000,000
Marital Deduction	0
Taxable Estate	25,000,000
Tax (40%)	10,000,000
Section 2010 Credit	(12,000,000)
Tax Due	$ 0

Now let's assume that Joan's property appreciates to $40 million over the 20 years in which Tracy survives her.

If Joan simply leaves all of her property to Tracy in a QTIP without the use of a credit shelter trust, the two collectively will pay $4 million in tax under our simple example.

Without a Credit Shelter Trust
An Increasing Estate Value Example
Joan's Form 706

Gross Estate	$ 25,000,000
Marital Deduction	(25,000,000)
Taxable Estate	0
Tax (40%)	0
Section 2010 Credit	(4,000,000)
Tax Due	$ 0

Without a Credit Shelter Trust
An Increasing Estate Value Example
Tracy's Form 706

Gross Estate	$ 40,000,000
Marital Deduction	0
Taxable Estate	40,000,000
Tax (40%)	16,000,000
Section 2010 Credit	(12,000,000)
Tax Due	$ 4,000,0000

Now let's assume that Joan uses a credit shelter trust and transfers to it $10 million, the amount of her available exclusion. Tracy will not include this property in her gross estate upon death. Also, let's assume that all of Joan's property increases to $40 million while Tracy survives her.

Therefore, the $10 million in the credit shelter trust increases to $16 million and the $15 million in the QTIP trust increases to $24 million.

Under these circumstances, the $1.6 million total estate tax paid between the two is significantly less than the $4 million total tax in the above example.

With a Credit Shelter Trust
An Increasing Estate Value Example
Joan's Form 706

Gross Estate	$ 25,000,000
Marital Deduction	(15,000,000)
Taxable Estate	10,000,000
Tax (40%)	4,000,000
Section 2010 Credit	(4,000,000)
Tax Due	$ 0

With a Credit Shelter Trust
An Increasing Estate Value Example
Tracy's Form 706

Gross Estate	$ 24,000,000
Marital Deduction	0
Taxable Estate	24,000,000
Tax (40%)	9,600,000
Section 2010 Credit	(8,000,000)
Tax Due	$ 1,600,000

The DSUE amount is not indexed for inflation. Therefore, there exists a planning opportunity to place the decedent spouse's assets that are expected to appreciate during the life of the surviving spouse into a credit shelter trust. This allows the decedent to pay his or her incident of wealth transfer tax when the property is lower in value—as compared to the property value when the surviving spouse passes years later.

The examples provided above are simplified and illustrate the savings for large estates. Nonetheless, this estate freeze opportunity should be considered by financial and estate planners, particularly when their clients have children from a prior marriage.

Summary and Conclusion

Often overlooked as an estate planning opportunity since the introduction of portability, the credit shelter trust remains a viable tax savings tool for estates above the exclusion amount.

By placing property that is expected to appreciate into a credit shelter trust, a decedent can transfer the property before its value increases by utilizing any remaining exclusion amount. This exclusion amount is not indexed for inflation once portability to the surviving spouse occurs.

For estates that are large enough to be subject to the federal estate tax, the overall tax savings associated with the use of the credit shelter trust can be substantial.

Notes:

1. 26 CFR § 20.2056(b)-1(b).
2. Id.
3. See §§2031 through 2046,
4. §2041. A surviving spouse has a general power of appointment if 1) the surviving spouse is entitled to all of the income from the transferred property for life, 2) such income is payable at least annually, or 3) the surviving spouse holds a power of appointment over the property that is exercisable in favor of the surviving spouse or the surviving spouse's estate.
5. §2044.
6. §2010.
7. The $10 million is effective for deaths after December 31, 2017, and before January 1, 2026. Prior to the 2017 Tax Cuts and Jobs Act, the basic exclusion was indexed from 2010 on $5 million. Without further action from Congress, in 2026 the basic exclusion amount will return to a number indexed from $5 million from the year 2010.
8. §2010(c).

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