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# Key Estate Planning Concepts That Every CPA Should Know for Their High Net Worth Clients

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## Credit Shelter Trust—Design Considerations

A Credit Shelter Trust [(CST), also known as a bypass trust, estate tax shelter trust, or family trust], is a type of irrevocable trust used by married couples with large estates to take full advantage of the federal estate tax exemptions. The federal exemption for 2019 is $11,400,000 per taxpayer, so proper use of this vehicle can allow a married couple to shield up to $22,800,000 of assets from federal estate tax.

The CST is most often created and funded when the first spouse dies. It is usually designed to benefit the surviving spouse (SS) and the deceased's children and grandchildren.

Note: A concept known as the Portability of the Unused Spousal Exclusion allows the SS to utilize the deceased spouse's remaining federal exemption without the use of a CST. It is important to note that portability cannot be used to apply the deceased spouse's generation skipping tax exemption (GSTE), is not recognized in most states, and does not allow assets that could have been sheltered by a CST to grow outside of the taxable estate.

Now let us consider some of the more important decisions when forming a CST.

### *Trustee(s) and principal distributions*

The trustee is the individual appointed to manage, invest, and distribute trust assets. While the SS can be named as the sole trustee of a CST, it is not generally recommended. Specific requirements must be followed to allow assets to remain outside of the taxable estate of the SS. If the SS is the sole trustee, then the trust agreement should only allow for distributions to be made to the SS under an ascertainable standard. That is, distributions should only be made to the surviving spouse for his or her health, education, maintenance, or support (commonly referred as "HEMS"). Unauthorized distributions can lead to lawsuits by other trust beneficiaries, claiming that distributions did not meet the trust's requirements. Additionally, depending on the state whose laws apply to the trust, a HEMS standard may not provide much creditor or liability protection, or protection from the claims of a divorcing spouse (assuming the SS remarried).

For example, imagine a court reviewing a trust that has a HEMS standard where the beneficiary is a senior citizen living in a nursing home. Depending on applicable state law, a court could find that the trustee is forced to make distributions to the beneficiary to pay for the cost of the nursing home. How could a trustee not be forced to make a distribution for the cost of that nursing home for their health?

Generally, our preference is to have an independent trustee as co-trustee with the SS. The independent trustee would be given broad discretion to make distributions (no HEMS standard is needed). To make sure the SS's needs are taken care of, we often will have the trust state that the senior generation's needs are to be taken into account first and foremost, before anyone else's.

Here is one potential issue: The fact that an independent trustee can be given very broad discretion is generally a good thing. However, what happens if the SS eventually becomes uncomfortable with the independent trustee? To address this, we often give the SS a remove and replace power, allowing them to remove and replace the independent trustee with another independent trustee. If for some reason (e.g., second marriage), it doesn't make sense to give that power to the SS, it may make sense to give that power to another party (sometimes referred to as a Trust Protector).

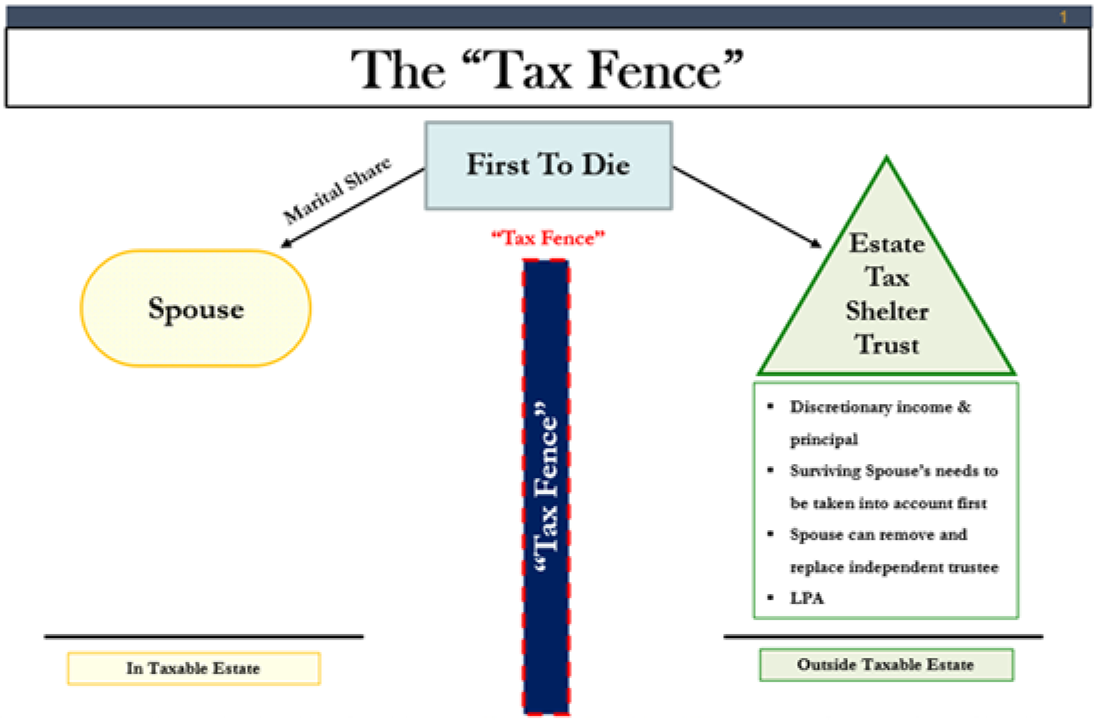
### *Income*

Trust income can be distributed in one of two ways: "mandatory income" or "discretionary income."

It is important to note that assets in the CST are outside the SS's taxable estate, and any asset titled under the SS's name will be taxable at his or her death. We like to explain this to clients by illustrating a "tax fence" (see diagram below), where assets outside of the fence are not included in the taxable estate of the SS. The goal is to have as many assets accumulate on the outside of the tax fence as possible, without impacting the SS's lifestyle.

With the "tax fence" depiction in mind, it becomes easier to understand why professional advisors prefer to have trusts that provide for discretionary distributions of income. If the trust provides the beneficiary with mandatory income, then the beneficiary must receive all the income each year, whether or not he or she needs it. In essence, this forces the income back through the tax fence, accumulating on the estate taxable side ultimately subjecting it to estate tax upon death of the SS.

With a discretionary income provision, the independent trustee can determine each year whether to distribute the income to the SS, another trust beneficiary, or to accumulate the income in the trust by adding it to the principal.




***Limited Power of Appointment***

A Limited Power of Appointment (LPA), or what is commonly referred to as a Second Look Provision, is used to allow the SS to change the final distribution of the trust assets upon his or her death. As this is an irrevocable trust once the first spouse dies, the trust needs to state what happens to the assets once the SS dies. Often, the trust will state that all assets will go equally either outright to, or in further trust for, the children.

However, what if the children's circumstances change dramatically after the first spouse dies? Wouldn't it be nice if the SS could change the ultimate distribution from equally to whatever he or she deemed appropriate at the time? A well drafted LPA allows that, without risking inclusion in the SS estate.

Note: In a second marriage, an LPA may not be appropriate or may be drafted with limitations as to what changes can be made.

**Generation Skipping Tax Exemption (GSTE)—To allocate or not to allocate?**

Just as the estate tax exemption allows assets to pass to children (the next generation) estate tax free, the use of GSTE allows assets to continue on to future generations (grandchildren, great grandchildren, etc.) transfer tax free.

There are certain trusts that are generally ideal for allocating GSTE and others that are not.

The CST is generally a good place to allocate GSTE if the trust is drafted to stay in place through the children's (and often future generations') lifetimes, as the assets in that trust may continue to grow outside the taxable estate for many generations.

If, however, the CST says the assets are to be distributed outright to the children at certain ages (e.g., one-third at 25, one-third at 30, and the balance at 40), then allocating GSTE would be a waste because the assets won't stay in trust long enough to benefit from the allocation.

Irrevocable life insurance trusts are often a good place to allocate GSTE because of the leverage that a life insurance policy provides. The GSTE is applied to the gifts made to the trust (often for the premiums) not to the death benefit, which is often much greater. As long as the policy stays in force through the insured's lifetime, and the trust stays in place through the children's lifetimes, allocating GSTE makes sense".

What about a life insurance trust that holds term insurance? As the vast majority of term insurance policies lapse before the insured dies, this would not be a good place to allocate GSTE.

What about the commonly used estate tax discounting techniques known as GRATs (grantor retained annuity trusts) or QPRTs (qualified personal residence trusts)? You would generally not want to allocate GSTE to these trusts. The reason is that, due to something called the estate tax inclusion period (ETIP), unlike the estate tax exemption, the GSTE would not be applied to the discounted value of the gift, but rather to the greater value that the asset grows to at the end of the trust term.

### *Automatic Allocations—Beware*

When filing gift tax returns, it is important to understand whether the client wishes to allocate GSTE to the trusts that are in place. In 2000, the tax code added what are known as automatic allocation rules where the GSTE is automatically allocated to certain trusts. This was put in place because of mistakes made by tax professionals who failed to allocate the GSTE (the tax consequences of which can be extremely onerous).

The practical problem with the automatic allocation rules is that it is not always clear which trusts are affected. For this reason, many top tax professionals recommend that gift tax returns be filed affirmatively addressing the GSTE allocation.

## Grantor Trusts

In larger estates, lifetime irrevocable trusts are commonly used to remove assets from the taxable estate (to the right side of the tax fence). To enhance the transfer tax benefits, those trusts can be designed so that the grantor (the individual creating the trust) can be taxed on the trust's income.

Why are grantor trusts a good idea? They increase the transfer tax savings because the assets in trust are outside of the taxable estate and grow unencumbered by income taxes (the trust does not pay any income taxes). At the same time, assets left inside the taxable estate (which will eventually be subject to estate tax), are now reduced by the income tax payable for the assets held in trust. In essence, this is like making a gift to the trust for its income taxes without it being treated as a gift.

***How can an irrevocable trust become a grantor trust for income tax purposes?***

There are many ways to make an irrevocable trust a grantor trust for income tax purposes. One of the most popular ways has been to purposely violate provisions of Internal Revenue Code (IRC) Section 675, which addresses certain administrative powers. In particular, if the grantor is given the power to reacquire the trust principal in a nonfiduciary capacity, Section 675 has been violated and the trust becomes a grantor trust.

The power to reacquire trust principal has become even more relevant since the increase in income tax basis planning that resulted from the higher federal estate tax exemptions. If one or more assets have been transferred to one of these trusts and have grown substantially in value, the grantor can swap assets and bring those low basis assets back into the taxable estate (for a future step up in basis upon death) in exchange for assets with higher basis (as assets in trust do not receive a step up in basis upon the death of the grantor).

Another reason this power is popular is that if an asset has appreciated significantly and there is a concern that it might not hold its value, the asset can be reacquired at its high value locking in the appreciation in the trust and outside of the taxable estate.

***Why have newer trusts not relied solely on the reacquisition clause discussed above to make a trust a grantor trust?***

The IRS has not opined on the question of what it means to reacquire assets in a "nonfiduciary capacity." Due to this uncertainty, many estate tax attorneys are still including the reacquisition clause, but are also adding additional language to provide more certainty that a trust will be treated as a grantor trust.

A popular provision used to ensure grantor-trust treatment is based on violating IRC Section 674, which says that if a party related to the grantor has the power to control the beneficial enjoyment of the trust, then the trust is a grantor trust. For example, if a grantor were to name his or her brother as a trustee and give him the power to control beneficial enjoyment of the trust, then it would likely be considered a grantor trust. Also, if the grantor's spouse is a trustee, it will often be considered a grantor trust.

**Summary**

The concepts summarized above are often used when planning for high net-worth estates (additional concepts such as the sale to an intentionally defective trust, the sale of remainder interests, private split dollar, etc., are beyond the scope of this article.). It is important to remember that every client's situation is different, so the preferences stated above should be modified to meet the goals of each individual. A well-designed estate plan is one that is tailored to meet the needs of each client.

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