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For years, the testamentary credit shelter bypass trust has been a staple of estate planning. Because current estate tax law allows an unlimited marital deduction for assets passing to a surviving spouse, the first spouse to die can leave everything to his or her spouse without paying estate taxes. However, since every U.S. citizen or resident can pass the applicable exclusion amount (see chart below) free of estate taxes, virtually half of this shelter will be lost if the first spouse to die leaves all of his or her property outright to the surviving spouse.

THE TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010


The *Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act* (“the Act”) was enacted on December 17, 2010. For 2011 and 2012, the Act provides for a \$5 million Federal gift, estate and generation skipping transfer tax exemption amount (indexed for inflation starting in 2012) and a top gift, estate and GST tax rate of 35%. On January 1, 2013, a \$1 million Federal gift, estate and GST exemption amount and a maximum gift, estate and GST tax rate of 55% is scheduled to go into effect.

Year of Death or Gift	Estate Tax Applicable Exclusion Amount	Maximum Estate/ Gift Tax Rates	Lifetime Gift Tax Exclusion
2011	\$5,000,000	35%	\$5,000,000
2012	\$5,000,000	35%	\$5,000,000
2013	\$1,000,000	55%	\$1,000,000

Wills or trusts can be structured to utilize any remaining credit at the first death (i.e., the surviving spouse is using the deceased spouse's unused credit*). Alternatively, an outright transfer of the applicable exclusion amount can be made to family members other than the spouse. If a donor does not want to give his or her heirs the money outright, the donor could create a "credit shelter bypass trust" (CSBT) in the will or revocable trust. The will or trust agreement will typically have language to fund the CSBT with assets worth the remaining applicable exclusion amount.

In order for a married couple to fully utilize the applicable exclusion amount (if desired), the first spouse-to-die must generally own assets at least equal in value to that amount. Some types of assets cannot utilize the credit. For example, assets the couple own as joint tenants with a right of survivorship pass automatically to the surviving spouse. Similarly, qualified retirement plans, IRAs, and life insurance pass directly to the surviving spouse if he or she is the designated beneficiary. These types of assets can pass free of estate tax under the marital deduction, but cannot be used to fund the credit shelter trust.

** In 2011 and 2012, an election can be made by the executor of the first spouse to die that will allow the surviving spouse to "carry over" the first-to-die spouse's unused exemption.*




In order to fund the trust, the couple may have to partition joint property into separate property so that each spouse has separate property worth the applicable exclusion amount (since the identity of the spouse to die first is usually unknown). Changing the beneficiary of qualified retirement plans and IRAs to someone other than the spouse can also fund the credit. However, there may be adverse tax consequences if the surviving spouse is not the beneficiary of these types of assets. Changing the beneficiary of life insurance can work also, but it may be better for estate tax purposes to simply transfer ownership of the policy altogether.

Spouses with community property may have an easier time funding the first spouse's unified credit because community property, while owned one-half by each spouse, does not pass automatically to the surviving spouse. The first spouse to die can use his or her share of the community property to fund the credit shelter trust.

LEVERAGING THE *Trust...*

Typically, in a CSBT, the surviving spouse is named the income beneficiary of the trust assets, with the remainder passing to the deceased's children and/or grandchildren. If the surviving spouse already has sufficient assets of his or her own, there may not be a need for additional income from the trust. In these circumstances, it may be beneficial for the trust to purchase a life insurance policy on the surviving spouse's life. The tax-deferred nature of life insurance cash value could reduce



or eliminate annual trust income, and the value of the trust at the surviving spouse's death could be substantially increased by the life insurance death benefit.


Before proceeding with the purchase, however, there are several issues that must be addressed.

DOES THE TRUSTEE HAVE AUTHORITY TO PURCHASE LIFE INSURANCE?

One of the first issues to be addressed is whether the trustee has the ability to purchase life insurance within the credit shelter trust. Most well-drafted trusts will contain language specifically authorizing the trustee to purchase life insurance. If the purchase of life insurance is contemplated in the planning stage, appropriate trust language can be drafted at that time. Even if life insurance is not specifically mentioned as a permissible trust asset, most trusts and/or state laws grant broad discretionary authority to the trustee to invest trust assets. Thus, if the trustee believes the purchase of life insurance is an advantageous investment, he or she will most likely have the authority to proceed with the purchase even in the absence of specific language.

DOES THE SURVIVING SPOUSE POSSESS INCIDENTS OF OWNERSHIP OVER THE POLICY?

Credit shelter trusts are typically used in estate planning to provide the surviving spouse with a lifetime benefit from the trust and some limited power to control the disposition of the trust assets at his or her death. It is also common to name the surviving spouse as trustee of




the trust. Both of these powers can be considered incidents of ownership under I.R.C. §2042, causing inclusion in the surviving spouse's estate. These issues must be addressed before proceeding with the insurance purchase.

◆ ***Does the Surviving Spouse Hold a Limited Power of Appointment Over the Trust?***

In some trusts, the surviving spouse is given a limited or special power of appointment that would allow him or her to change the beneficial interest of the trust assets. For example, a trust could require assets to be distributed to the deceased spouse's children, unless the surviving spouse directs otherwise in his or her will. If a life insurance policy was owned by the trust, the ability to change the beneficial interest of the death proceeds would most likely cause inclusion of the life insurance proceeds in the surviving spouse's estate at his or her death.

To avoid this consequence, care should be taken when the trust is drafted to specifically exclude any life insurance policy on the surviving spouse's life from the power of appointment (see PLR 9111028). Alternatively, a provision in the trust could be made to void the entire power of appointment if the trust acquires a life insurance policy on the life of the surviving spouse (see PLR 9602010).

If, however, the trust has already been funded, it may be possible for the surviving spouse to disclaim his or her special power of appointment. Under I.R.C. §2518 this disclaimer must be made within nine months of the date of the deceased spouse's death. If



the purchase of life insurance is desired past that date, state law may allow a release of the power of appointment .


◆ ***Does the Surviving Spouse Possess “Five and Five” Powers Over the Trust?***

In some instances, the surviving spouse, as beneficiary of the trust, may be allowed to withdraw an amount equal to the greater of \$5,000 or 5% of the trust balance each year. If the trust has sufficient assets other than life insurance to satisfy the withdrawal power, the life insurance policy might not be included in his or her estate, though this is unclear. However, if sufficient other assets do not exist, the surviving spouse’s “five and five” power may be considered an incident of ownership resulting in estate tax inclusion.

◆ ***Is the Surviving Spouse a Trustee of the Trust?***

Often, the surviving spouse is named trustee of the trust. This power alone will not generally cause inclusion in his or her estate as long as the trustee’s authority to pay trust principal to himself or herself is limited by ascertainable standards. If, however, a life insurance policy is owned by the trust on the surviving spouse/ trustee’s life, he or she may be able to exercise fiduciary powers for his or her own benefit and an incident of ownership under I.R.C. §2042 could be deemed to exist, causing the proceeds of the life insurance policy to be includible in the surviving spouse’s taxable estate (Rev. Rul. 84-179, 1984-2 C.B. 195).

One way to possibly prevent this problem is to specifically limit the trustee’s authority over the life insurance policy (See PLR 9111028). A “special trustee” (someone other than the surviving




spouse) could be named for purposes of exercising any incidents of ownership over the life insurance policy. If the trust is already in effect, the surviving spouse could resign as trustee prior to the purchase of a life insurance policy (See PLRs 9434028 and 9748020). Resignation after the purchase of a policy would trigger the “three-year rule”, and the surviving spouse would have to survive three years from the date of his or her resignation to avoid having the life insurance death benefit included in his or her gross estate (I.R.C. §2035).

◆ *Is the Surviving Spouse a Beneficiary of the Trust?*

If the surviving spouse is merely an income beneficiary of the trust (not a trustee), this right to receive distributions alone should not cause the life insurance to be includible in his or her estate (See PLRs 9748020 and 9602010).

Conclusion...

- ◆ When appropriate, owning life insurance in a credit shelter trust may be an excellent method of achieving maximum leverage of the deceased spouse’s applicable exclusion amount. The most appropriate time to address the issue is during the planning stages, however, it may be possible to complete a life insurance purchase after the death of the first spouse to die, if the trust has been drafted with sufficient flexibility. In all cases, a qualified estate planning attorney should be consulted.

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- ◆ Additionally, the implications of the new tax law and the subsequent reversion back to the current law should be considered by clients with their estate planning attorney and other professional advisors. Existing estate planning documents should be reviewed for appropriateness. New estate planning documents should be flexible enough to comply with the tax law and to ensure that the client's wishes are fulfilled.



Spouse

If the surviving spouse is the trustee and beneficiary of the CSBT, he or she must resign. If the resignation is received after the life insurance policy has been purchased, he or she must survive three years to avoid inclusion within his or her taxable estate.

If the surviving spouse has a special or limited power of appointment over the CSBT, he or she must disclaim or release that interest prior to the purchase of life insurance.



Credit Shelter Bypass Trust

Assets equal to the applicable exclusion amount are received from the estate.

If the surviving spouse does not need the income from the CSBT, and other requirements are met, the trust assets may be used to purchase a life insurance policy on his or her life.

At the spouse's death, assets passing to heirs can avoid estate taxes.



Trustee pays premium



Pays death benefit



Trust distributes assets



New York Life


Receives premium dollars from the trustee of the CSBT.

At the insured's death, New York Life pays death proceeds to the trustee.

Heirs

The heirs receive distributions from the trust according to the terms of the trust agreement.

Owning life insurance in a Credit Shelter Bypass Trust (CSBT) may be an excellent method of achieving maximum leverage of the deceased spouse's applicable exclusion amount.



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