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# Supercharged Credit Shelter Trust

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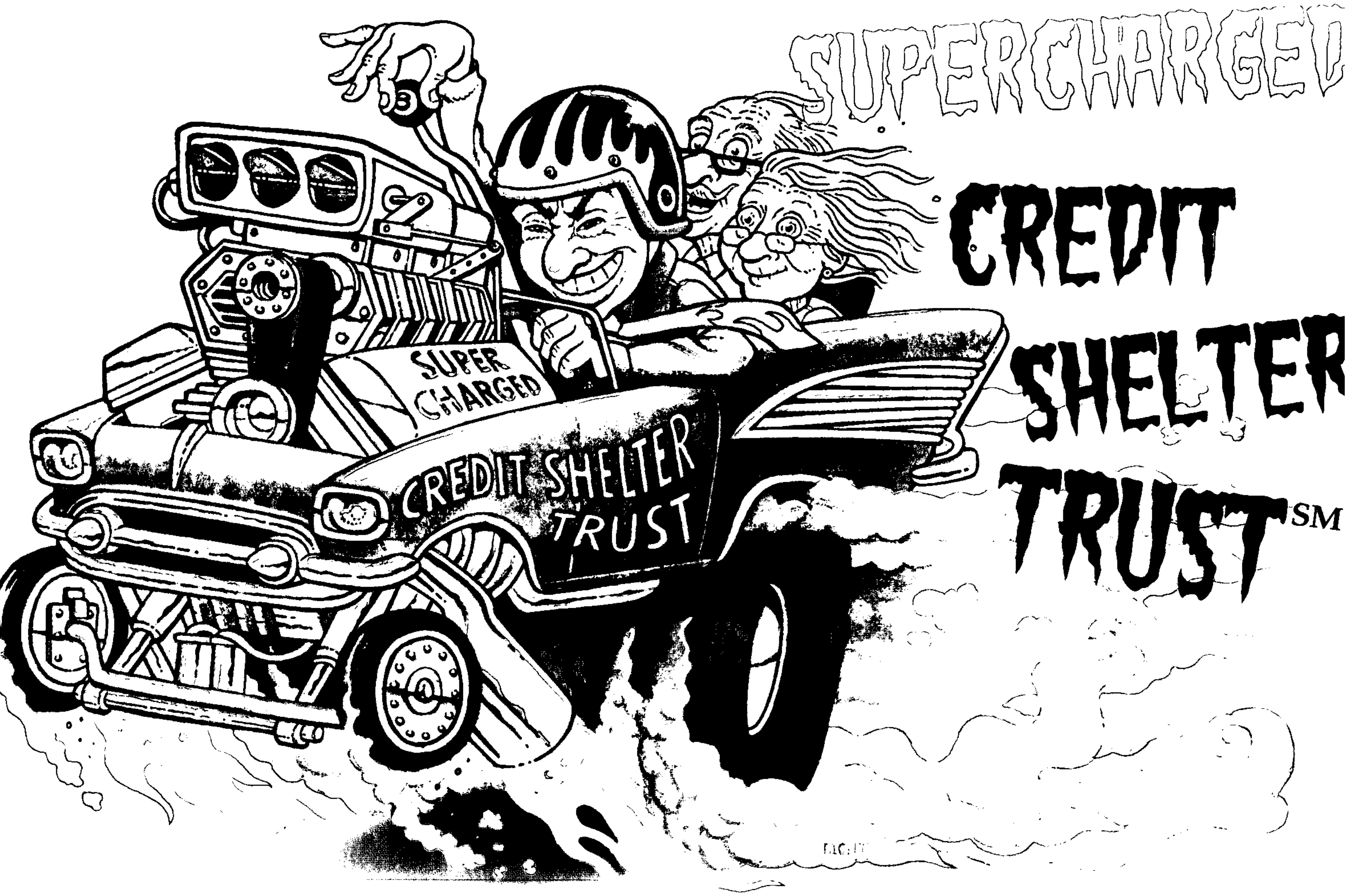


**By Mitchell M. Gans, Jonathan G. Blattmachr, and Diana S. C. Zeydel**

Many married individuals adopt an estate plan designed to avoid estate tax on the death of the first spouse to die while taking maximum advantage of the so-called unified credit (also known as the applicable exclusion amount). The plan typically involves setting apart the amount sheltered by the unified credit (the "credit shelter" amount) separately and providing that only the portion of the estate in excess of the credit shelter amount will pass in a manner that qualifies for the marital deduction. Frequently, the credit shelter amount is set apart in trust so that the surviving spouse may benefit from the property if needed without causing those assets to be included in the surviving spouse's estate for estate tax purposes. A credit shelter trust not only preserves the unified credit of the first spouse to die but also provides an opportunity to leverage the unified credit of the first spouse to die during the lifetime of the surviving spouse: to the extent there is appreciation and/or accumulated income in the trust, it passes on the surviving spouse's death free of estate tax (and free of generation-skipping transfer tax, assuming an allocation of GST exemption to the trust). The amount in the trust passing tax-free at the surviving spouse's death is enhanced, of course, if trust distributions to the surviving spouse are minimized. The amount in the trust would be further enhanced if the credit shelter trust were the surviving spouse's grantor trust: the surviving spouse's payment of tax on the trust's income would permit the trust estate to grow income tax free. The trust, in other words, would be supercharged. This article will suggest that a lifetime QTIP trust should be used to supercharge the credit shelter trust. Given the advantage

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Max Licht

offered by the Supercharged Credit Shelter Trust℠, practitioners may wish to consider adopting this drafting approach in many cases.

### Background

The unified credit is typically conceptualized as a federal estate tax exemption or exemption equivalent. The exemption has increased from $60,000 (when it was a true exemption) for many years before 1977 to the current amount of $2 million (and it increases in 2009 to $3.5 million). Under current law, there is no federal estate tax in 2010 (so one could view the exemption as unlimited for that year). After 2010, the exemption would revert to $1 million. See section 2010 of the Internal Revenue Code of 1986 as amended ("Code").

In a conventional plan, the first spouse to die does not bequeath all of his or her assets to the surviving spouse via a bequest or other disposition that qualifies for the marital deduction. Were such an approach used, the first spouse's exemption would be wasted. Rather, the exemption amount is typically bequeathed in trust, with the surviving spouse as a beneficiary. As long as the surviving spouse is not given a general power of appointment, its assets will be excluded from the surviving spouse's gross estate for federal estate tax purposes.

### Credit Shelter Trusts

Typically, the plan designed fully to use the exemption of the first spouse to die is implemented through a "formula" bequest, under which an amount equal to the spouse's unused federal estate tax exemption is placed in a trust for the benefit of the surviving spouse and descendants. The trust shelters the assets used to fund the exemption from inclusion in the surviving spouse's gross estate for federal estate tax purposes: neither Code § 2036 nor Code § 2038 can apply because the surviving spouse makes no transfer to the trust; and, if properly drafted, the surviving spouse does not have a general power of appointment over trust assets. Because the trust shelters the amount based on the unified credit (that is, the unused exemption) from estate tax in this fashion, it is commonly referred to as a "credit shelter trust."

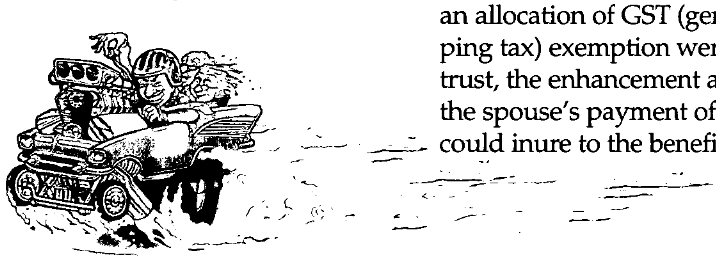
### Structure and Benefits of the Credit Shelter Trust

Some clients may insist on mandating distributions of trust income to the surviving spouse from the credit shelter trust. Although that may provide a sense of psychological and economic security, it is inefficient from a tax viewpoint. Amounts distributed to the surviving spouse, to the extent not expended, will have the effect of increasing his or her gross estate, whereas amounts accumulated in the trust will pass, as indicated, free of estate tax at the surviving spouse's death. In addition, distributions to the surviving spouse will have the effect of depleting a tax-exempt trust when it might be possible to provide for the spouse out of what would be estate taxable assets. Moreover, during the surviving spouse's lifetime, income could be distributed to descendants without incurring gift tax. For example, if the trust mandated income distributions to the surviving spouse and he or she then gifted the income received to a child, a taxable gift would occur (to the extent not protected by the annual exclusion under Code § 2503). But, if authorized in the instrument, the income could be distributed by a disinterested trustee directly to the child without generating a taxable gift. (An interested trustee, one who is a beneficiary of the trust, could also make the distribution without generating a taxable gift if the trust instrument permits distributions to be made in accordance with an ascertainable standard, such as health, maintenance, support, and education.) In addition, the income distribution to the child might produce income tax savings: the distribution should be taxable for income tax purposes to the child, and, if the child is in a lower income tax bracket than the surviving spouse, the difference in bracket will result in savings. Even if the income is accumulated in the trust, savings may be achieved: whereas a distribution to the spouse could generate state or local income tax, it is possible that the trust might not be subject to such a tax.

When the surviving spouse has sufficient resources, he or she should not receive distributions from the trust. In other words, to achieve an optimal tax outcome for the entire family, the surviving spouse should expend his or her own assets (or those in the marital deduction trust) rather than receive distributions from the credit shelter trust. To illustrate, assume that the surviving spouse has access to the following categories of assets: assets held outright by the surviving spouse, assets held in the credit shelter trust, and assets held in one or more marital deduction trusts. Because only the assets held in the credit shelter trust will pass estate tax free at the surviving spouse's death, it would be preferable to use principal in the marital deduction trust (as it is generally the case that the marital deduction trust will mandate income distributions), rather than principal or income in the credit shelter trust, to enable the surviving spouse to maintain an appropriate standard of living. Under this approach, the assets in the marital deduction trust (estate taxable when the surviving spouse dies) "vanish" while the assets in the credit shelter trust (not estate taxable when the surviving spouse dies) grow. This can be accomplished if the trustee is authorized to distribute principal from the marital deduction trust(s) to the surviving spouse and to accumulate income in the credit shelter trust (in addition, as suggested, it may be helpful from a planning perspective if the trustee of the credit shelter trust were authorized to make distributions to descendants). When it is anticipated that the credit shelter and marital deduction trusts will be so administered, it may be appropriate to provide detailed authorization to the trustees and, indeed, to encourage them to use this approach. A sample provision might read as follows:

> *Estate Tax Efficient Shares*
>
> I have provided in this instrument, if my spouse survives me, for my estate to be divided into what I per-

ceive to be estate tax efficient shares for those who may succeed to property disposed of hereunder upon the death of my spouse. I understand that the relative size of those shares is dependent upon the tax law in effect at the time of my death and upon elections or other decisions made by my executors/personal representatives. I acknowledge that the interest of my spouse in the shares created hereunder may not be the same and that, if there is no death tax in effect at the time of my death, no estate tax marital deduction share may be created for my spouse. Because benefiting my spouse is one of my primary concerns, I request, but do not direct, that the Trustees of any trust hereunder in which my spouse has an interest benefit my spouse therefrom in a manner that will eliminate or minimize the economic effect upon my spouse of the division of property into separate shares; provided, however, that only a Trustee other than any Trustee who is or in the future may become a beneficiary of a trust hereunder who is referred to herein as an "Interested Trustee" shall participate in any such decision. Without limiting the discretion granted to the Trustees hereunder, without granting my spouse any right to compel the Trustees to do so, and without imposing any obligation for the Trustees to do so, and solely by way of illustration and not limitation, I authorize the Trustees (other than any Interested Trustee) to pay principal to my spouse from any trust that qualifies for the Federal and/or state estate tax marital deduction while accumulating income in any other trust in which my spouse may have an interest in a manner that the Trustees (other than any Interested Trustee) determine may provide my spouse with approximately the same net benefit (taking into account income taxes and any other factors the Trustees (other than any Interested Trustee) deem appropriate) my spouse would have received had all income or a reasonable unitrust amount, as determined by the Trustees (other than any Interested Trustee), from all trusts in which my spouse has an interest hereunder been paid to my spouse.



### Supercharging the Credit Shelter Trust

As suggested, in a conventional plan the credit shelter trust is created by bequest. Under subchapter J of the Code's income tax provisions, unless the trust is a grantor trust under subpart E of part 1 of subchapter J, the income taxation of a trust's income is based on the concept of distributable net income (DNI). Under those DNI rules, the trust's income is taxable to the beneficiaries or the trust depending on the amount of distributions made each year. See Code §§ 651–662. Thus, if income distributions to the surviving spouse are mandated or made in the discretion of the trustee, they will be taxed under the DNI rules to the spouse, as a general rule. If, on the other hand, the trust's income is either accumulated or distributed to descendants, it will, of course, not be taxed to the spouse. Suppose, however, the DNI rules could be displaced with the grantor trust rules so that the trust's income, therefore, would be made taxable to the spouse even if no distributions are made to the spouse. (Under the grantor trust rules, the income, deductions, and credits against tax of the trust are attributed directly to the grantor as though the trust does not exist and the trust assets were owned directly by the grantor.) If this could be accomplished, the trust would grow income tax free and thus, in effect, would be enhanced by the spouse's income tax payments. And, assuming an allocation of GST (generation-skipping tax) exemption were made to the trust, the enhancement attributable to the spouse's payment of the income tax could inure to the benefit of lower-generation beneficiaries on a completely transfer-tax-free basis. The credit shelter trust would thus become "supercharged."

How might one structure a credit shelter trust to supercharge it? At bottom, the concept rests on Rev. Rul. 2004-64, 2004-2 C.B. 7. In the ruling, the IRS considered the gift tax implications of a grantor trust. In the case of a grantor trust, the DNI rules do not apply. Instead, the trust is ignored for income tax purposes and its income is taxed to the grantor. See Rev. Rul. 85-13, 1985-1 C.B. 184. In Rev. Rul. 2004-64, the IRS concluded that the grantor's payment of the tax on the income of a grantor trust does not constitute a taxable gift. For a discussion of the ruling, see M. Gans, S. Heilborn & J. Blattmachr, *Some Good News About Grantor Trusts: Rev. Rul. 2004-64*, 31 Est. Plan. No. 10, at 467 (Oct. 2004). Thus, if a credit shelter trust could be structured so that it was the surviving spouse's grantor trust for income tax purposes while still functioning as a credit shelter trust for transfer-tax purposes (no inclusion in the surviving spouse's estate), it would be supercharged.

The difficulty, however, is that, under conventional planning, the surviving spouse is not the grantor of the credit shelter trust. The trust is created by bequest under the will (or revocable trust) of the first spouse to die and, therefore, cannot be viewed as the surviving spouse's grantor trust. Nonetheless, under Code § 678, the trust could qualify as the surviving spouse's grantor trust if he or she were given the right to withdraw the trust principal. Although this would be effective in terms of making the trust's income taxable to the spouse, it would be ineffective in terms of the estate tax: such a withdrawal power is a general power of appointment that would cause the trust's assets to be included in the surviving spouse's gross estate under Code § 2041 (and a release or lapse of the power during the surviving spouse's life would trigger a taxable gift under Code § 2514 to the extent not saved by the "five-and-five" exception in Code § 2514(e)). The critical question, therefore, is how to make the credit shelter trust the surviving spouse's grantor trust without relying on Code § 678.

### Lifetime QTIP Trust for the Spouse Dying First

This can be achieved through the use of a lifetime QTIP trust. To illustrate, assume the wife creates a lifetime QTIP trust for her husband with sufficient assets to use his entire estate tax exemption when he dies. She elects QTIP treatment for the trust on her U.S. Gift (and Generation-Skipping Transfer) Tax Return (Form 709). (Note that it will not qualify for the marital deduction if the spouse for whom the QTIP is created is not a U.S. citizen. See Code § 2523(i).) Thus, no gift tax is payable when the trust is created, and the entire trust will be included in the gross estate of the husband when he dies under Code § 2044. While both spouses are alive, the trust is the wife's grantor trust (assuming her husband is a beneficiary for both trust income and principal, the trust is deemed wholly owned by the wife). See Code §§ 676, 677. Therefore, all of the trust's income (whether allocated to accounting income or to principal) would be taxed to the wife without regard to the DNI rules.

On the husband's death, as indicated, the assets in the lifetime QTIP trust created by the wife for the husband are included in his gross estate under Code § 2044. But estate tax will be avoided to the extent of his remaining federal estate tax exemption (and for the entire trust if any assets in excess of the husband's remaining exemption pass in a form that qualifies for the marital deduction for estate tax purposes in his estate). And, assuming the trust is properly drafted, its assets (to the extent of the husband's estate tax exemption) should not be included in the wife's gross estate at her later death. Even though she may be a permissible (or even mandatory) beneficiary of the credit shelter trust created from the lifetime QTIP trust, it will not be included in her gross estate as long as she does not have a general power of appointment and as long as the husband's executor does not make a QTIP election. Although, under Code § 2036, trust assets may ordinarily be included in the grantor's gross estate when the grantor is a beneficiary, the QTIP regulations explicitly preclude the IRS from invoking Code § 2036 or Code § 2038 in the surviving spouse's estate in the case of such a lifetime QTIP. See Treas. Reg. § 25.2523(f)-1(f), ex. 11. Thus, even if the credit shelter trust is drafted to permit distributions to the wife, it will not be included in her gross estate. In effect, the trust functions exactly as would a credit shelter trust formed from assets in the husband's own estate: a trust using his exemption would be excluded from the wife's gross estate at her later death.

Nonetheless, for income tax purposes, the trust can continue to be treated as the wife's grantor trust after the husband's death, provided the trustee has discretion to make distributions of income and principal to the wife. Regardless of the way in which the trustee in fact exercises this discretion, the trust's taxable income will continue to be attributed to the wife under the grantor trust rules by reason of the wife's discretionary interest in trust income and principal. See Code §§ 676, 677. Most critically, the wife is viewed as remaining the grantor of the trust for income tax purposes—thus triggering Code § 676 and/or Code § 677—even though, at her husband's death, it was included in his gross estate under Code § 2044. See Treas. Reg. § 1.671-2(e)(5) (no change in identity of the grantor unless someone exercises a general power of appointment over the trust). As a result, the wife's payment of the tax on the trust's income does not constitute a taxable gift. See Rev. Rul. 2004-64, supra. Thus, even assuming the trustee accumulates the income or distributes it to the descendants, the wife is required to pay the income tax and is not treated as making a taxable gift when she does so. In short, the credit shelter trust is supercharged. And if GST exemption is allocated to the lifetime QTIP trust as is permitted in Treas. Reg. § 26.2632-1(c)(2)(ii)(C) and as explained in J. Blattmachr, *Selected Planning and Drafting Aspects of Generation-Skipping Transfer Taxation*, Chase Rev. (Spring 1996), the transfer tax savings will be further enhanced (although Rev. Rul. 2004-64 does not make explicit reference to the GST, its conclusion that no taxable gift occurs by reason of the grantor's payment of the income tax should likewise apply for GST purposes; see Treas. Reg. § 26.2652-1).

It is appropriate parenthetically to discuss the allocation of GST exemption in a bit more detail here. As explained in the *Chase Review* article cited above, the spouse who creates the lifetime QTIP trust may make the so-called reverse QTIP election under Code § 2652(a)(3) when the lifetime QTIP trust is created. In other words, the GST exemption of the first spouse to die will not be allocated to the credit shelter trust formed from that lifetime QTIP trust. Rather, the GST exemption of the spouse who created it will be allocated and allocated earlier in time than will the estate tax exemption of the spouse dying first. An example may help illustrate this concept. It is quite certain the husband will die before the wife will. She creates a $2 million lifetime QTIP trust for him. Although she makes the QTIP election to make the trust qualify for the gift tax marital deduction under Code § 2523(f), she "reverses" that election under Code § 2652(a)(3) for GST tax purposes. Hence, her GST exemption begins to "work" as soon as she creates the trust. Assume that when the husband dies, the lifetime QTIP trust is worth $3 million. The first $2 million goes into a credit shelter trust for the surviving spouse and is GST exempt by reason of *her* allocation of *her* GST exemption to the trust. The extra $1 million in the lifetime QTIP trust the wife created for the husband goes into a QTIP trust for her, which the husband's executor will elect to qualify for the estate tax marital deduction under Code § 2056(b)(7). And it too will be GST exempt, again by reason of the wife's allocation of GST exemption to the lifetime QTIP trust when she created it. The husband's GST exemption will be allocated to other assets in his estate—these other assets presumably will pass into a so-called reverse QTIP trust for the wife. Hence, this strategy not only supercharges the estate tax exemption of the spouse who dies first but, as explained in the *Chase Review* article, "extra" supercharges the GST exemption of the surviving spouse. Of course, as with all lifetime uses of tax exemptions, there is a risk that exemption is wasted if the assets decline in value. If, in the foregoing example, the assets decline to $1.5 million, the husband's estate tax exemption will remain intact, but a portion of the wife's GST exemption may be wasted.

### Creditors' Rights Doctrine

Under the law of most, but not all, states, a grantor's creditors may attach assets in a trust the grantor has created and from which he or she is entitled or eligible in the discretion of a trustee to receive distributions. See, e.g., N.Y. Est. Powers & Trusts Law § 7-3.1; *Restatement (3d) of Trusts* §§ 57–60. The question becomes whether estate tax inclusion in the estate of the spouse who created the QTIP that becomes a credit shelter trust for that spouse might result if, under state law, her creditors could reach the trust's assets.

Because the wife in the above example is the grantor of the lifetime QTIP trust and also will be a permissible beneficiary of the resulting credit shelter trust, it is at least arguable that, under state law, her creditors could attach the trust's assets. Ordinarily, the ability of a grantor's creditors to reach trust assets triggers inclusion in the gross estate under Code § 2036. See, e.g., *Outwin v. Commissioner*, 76 T.C. 153 (1981), acq. 1981-2 C.B. 1; *Palozzi v. Commissioner*, 23 T.C. 182 (1954), acq. 1962-1 C.B 4; *Estate of Paxton v. Commissioner*, 86 T.C. 785 (1986); Rev. Rul. 77-378, 1977-2 C.B. 348. As indicated, however, the QTIP regulations explicitly preclude the IRS from invoking Code §§ 2036 and 2038 in this context. See Treas. Reg. § 25.2523(f)-1(f), ex. 11 (foreclosing the application of Code §§ 2036 and 2038 in the surviving spouse's gross estate for a QTIP trust previously included in the other spouse's gross estate under Code § 2044).

Is it nonetheless possible that the IRS could successfully argue that, because of the right of the wife's creditors to reach the trust's assets, she has a general power of appointment triggering inclusion in her estate under Code § 2041? Although the QTIP regulations render Code §§ 2036 and 2038 inapplicable in the wife's estate, they do not rule out the possible application of Code § 2041. Although Treas. Reg. § 20.2041-1(b)(2) may be read to say that the transferor of property cannot be deemed to hold a general power of appointment under Code § 2041, it is appropriate to mention that the QTIP rules make the spouse who is the beneficiary of a lifetime QTIP trust the transferor of the trust property for estate and gift tax purposes once the trust is created. Example 11 to Treas. Reg. § 25.2523(f)-1(f) says: "S [the spouse for whom the lifetime QTIP trust was created] is treated as the transferor of the property." In addition, that is consistent with Code § 2044(c) ("For purposes of this chapter . . . , property includible in the gross estate under subsection (a) shall be treated as property passing from the decedent").

So if the spouse for whom the QTIP trust was created is the transferor for estate and gift tax purposes, it seems completely logical that that spouse could "create" a general power of appointment for the grantor spouse. For example, a wife creates a lifetime QTIP trust for her husband and gives him a testamentary special power of appointment. When he dies, the trust is included in his estate under Code § 2044 and he exercises his special power of appointment to grant his wife a general power of appointment. It seems virtually certain the trust will be in the wife's estate under Code § 2041, even though she was the creator of the QTIP. The same result should obtain (that is, inclusion in the wife's gross estate) if she structured the lifetime QTIP trust to grant herself a general power of appointment on her husband's death because the husband would nevertheless, by reason of the application of Code § 2044, have become the transferor before the existence of the wife's general power of appointment. Hence, if under applicable state law, the wife's creditors could reach the assets of the credit shelter trust, Code § 2041 could apply in her estate and would make this strategy unworkable because it would cause the credit shelter trust to be included in her gross estate. It is critical, in other words, that the plan be structured so that Code § 2041 cannot apply in the wife's estate to the credit shelter trust for her benefit formed out of the lifetime QTIP trust she created for her husband.

This can be accomplished in one of two ways. First, Code § 2041 can be negated through the use of an ascertainable standard relating to health, education, maintenance, or support. For example, if distributions from the credit shelter trust to the wife were limited by such a standard, Code § 2041 could not apply in her estate even if her creditors could access the trust's assets under state law. In those states permitting creditors access, creditors will typically only be able to reach the amount that the trustee could distribute to the grantor under a maximum exercise of discretion. See, e.g., *Vanderbilt Creditor Corp. v. Chase Manhattan Bank, NA*, 473 N.Y.S.2d 242 (App. Div. 1984); comment f to *Restatement (3d) of Trusts* § 60. Thus, in such jurisdictions, if the trustee can make distributions only to the extent necessary for the grantor's health, education, maintenance, and support, the grantor's creditors are similarly limited. They can reach the trust's assets only to the extent the trustee could properly make payments to the grantor for such purposes. And because Code § 2041 excludes from the definition of a general power of appointment a right to property circumscribed by such a standard, including an appropriate standard in the instrument would preclude the IRS from invoking Code § 2041, even if the trust were located in a state permitting creditors access. (Further limitations also might be incorporated, such as requiring the trustee to consider other resources before making distributions.) Practitioners should carefully check applicable state law to ensure that creditors of the grantor would be so limited in their access to the trust property.

Second, the trust could be formed under the laws of a state that does not permit the grantor's creditors to access trust assets. When the law of such a state controls (Alaska, Delaware, Nevada, Rhode Island, South Dakota, Utah, and, to a limited extent, Oklahoma), it will be respected for federal estate tax purposes. See, e.g., *Estate of German v. United States*, 7 Ct. Cl. 641 (1985) (no estate tax inclusion in estate of grantor who was eligible to receive income and corpus from the trust because her creditors could not attach the trust property under the law under which the trust was created); see also Rev. Rul. 2004-64.

In sum, when using a Supercharged Credit Shelter Trust℠, it is critical to (1) include an appropriate standard in the instrument and/or (2) locate the trust in a state where the grantor's creditors cannot reach trust assets. Failure to do so could potentially result in inclusion of the trust in the surviving spouse's estate. If the suggested approach is used, the lifetime QTIP trust becomes a credit shelter trust for the first spouse to die for transfer tax purposes while remaining the surviving spouse's grantor trust for income tax purposes, thereby permitting the credit shelter trust to appreciate on an income tax free basis. Given the substantial amount of additional wealth that can be transferred tax free with the supercharged version of the credit shelter trust (see the table on page 58), practitioners should give the approach serious consideration in all cases in which the spouses are willing to consider committing assets to a lifetime trust arrangement.

### Reciprocal Lifetime QTIP Trusts: Estate Tax

Under the proposal, instead of creating testamentary credit shelter trusts under the wills or revocable trusts of both spouses, each spouse creates a lifetime QTIP for the benefit of the other, with sufficient assets in each trust fully to use the beneficiary-spouse's exemption. This, of course, raises the question whether the "reciprocal trust doctrine" will undermine the effectiveness of the strategy.

In *United States v. Estate of Grace*, 395 U.S. 316 (1969), the Supreme Court applied the doctrine to the following facts. A husband had created a trust under which the wife was entitled to receive the income for life; the wife was given a special power of appointment exercisable in favor of their descendants and the husband. Fifteen days later, the wife created a similar trust containing the same dispositive provisions for the benefit of the husband. Emphasizing the fact that the trusts were identical and created in the same time frame, the Court held that, at the husband's death, the trust created by the wife should be included in his gross estate under an earlier version of Code § 2036. Although a trust created for the benefit of the decedent by another party is not includible in the decedent's estate under Code § 2036, the Court nonetheless invoked the section on the theory that, in substance, the husband was the grantor of the trust nominally created by the wife. In other words, the husband, in substance, created the trust under which he was the income beneficiary. And, under Code § 2036(a)(1), a trust is included in the estate of the grantor if the grantor retained the right to the income for life. It is important to note that, had the Court respected the form of the transaction, neither trust would have been subject to estate tax: the trust created by the husband could not be included in his estate because he did not retain the right to its income, and it could not be included in the wife's estate because, although she had the right to the income, she was not the grantor (under a parallel analysis, the trusts created by the wife would similarly be excluded from both estates). For a further discussion of *Grace* and the reciprocal trust doctrine, see G. Slade, *The Evolution of the Reciprocal Trust Doctrine Since* Grace *and Its Current Application in Estate Planning*, 17 Tax Mgmt. Est. Gifts & Tr. J. 71 (1992).

At first blush, it would seem that the reciprocal trust doctrine should apply when husband and wife simultaneously create lifetime QTIP trusts for each other. Indeed, the case for applying Code § 2036 in this context may not even depend on the applicability of the doctrine. For if the surviving spouse is entitled to receive income from the trust he or she created after the death of the other spouse, the section applies without regard to the doctrine. See Treas. Reg. § 20.2036-1 (applying the section when the grantor retains the right to the income after the income interest given to another person terminates). On closer analysis, however, Code § 2036 cannot apply in the QTIP context, whether based on the reciprocal trust doctrine or otherwise. As indicated, the QTIP regulations preclude the IRS from invoking Code § 2036 in the surviving spouse's estate. See Treas. Reg. § 25.2523(f)-1(f), ex. 11. Thus, the doctrine cannot be used for the purpose of including a QTIP trust created by the surviving spouse in his or her estate. Indeed, given the QTIP regulations, the doctrine is entirely irrelevant for estate tax purposes in the case of simultaneously created QTIP trusts. It would appear, moreover, to be irrelevant in this context for a second, independent reason: whereas, in *Grace*, neither trust would have been subject to estate tax had the form been respected, Code § 2044 requires that each QTIP trust be included in the estate of the beneficiary-spouse. Thus, unlike in *Grace*, there is no need to disregard the form to prevent a problematic estate tax outcome. For an argument that the doctrine cannot apply when the trust will otherwise be included in the estate of one of the spouses, see R. Covey, *Practical Drafting*, Oct. 1993, at 3402.

There is at least one other reason why the reciprocal trust doctrine may not apply. The "uncrossing" of the lifetime QTIP trusts is unimportant in and of itself as far as estate tax inclusion is concerned as one of those trusts will be included in the gross estate of the first spouse to die (under Code § 2044, if the doctrine does not apply, and under Code § 2036(a)(1), if it does) and the other in the estate of the surviving spouse (also under one of those sections), as discussed above. The real issue is whether the application of the

**Amount in Credit Shelter Trust at Death of Surviving Spouse**

**Assumptions: $2 million initial funding; 8% annual return; 25% effective income tax on undistributed income; amount in trust (in millions).**

| Years Between Deaths of Spouses | Payment to Spouse Each Year @ 4% | No Payment to Spouse (Spouse Not Taxed) | No Payment to Spouse (Spouse Pays Income Tax) |
|---|---|---|---|
| 5 | $2.32 | $2.68 | $2.94 |
| 10 | 2.69 | 3.58 | 4.32 |
| 15 | 3.12 | 4.79 | 6.34 |
| 20 | 3.61 | 6.41 | 9.32 |
| 25 | 4.19 | 8.58 | 13.7 |

doctrine would cause the credit shelter trust to be included in the gross estate of the surviving spouse. As indicated, the doctrine applies only when there are two trusts (which under the doctrine are "uncrossed"). Two credit shelter trusts would not be formed from the lifetime QTIP trusts—only one. And this trust, at least under general tax principles, is a separate trust from the lifetime QTIP trust that precedes it. Because there is only one credit shelter trust, there is nothing for it to be reciprocal to. Moreover, as explained above, the credit shelter trust, in fact, is created by the surviving spouse, raising the possibility of estate tax inclusion under Code § 2041 on account of the creditors' rights doctrine (which is "blocked" by limiting distributions to that spouse under an ascertainable standard). If the doctrine applies to the lifetime QTIP trusts *and also to* the successor credit shelter trust from the lifetime QTIP trust, then the surviving spouse is not treated, for estate tax purposes, as creating the credit shelter trust—rather, the credit shelter trust will be treated as created by the spouse dying first—and that, of course, should totally foreclose the possibility of estate tax inclusion (although, as discussed below, it could destroy the "supercharged" aspect of the arrangement if the doctrine were applied for grantor trust purposes as well).

### Reciprocal Lifetime QTIP Trusts: Gift Tax

The gift tax analysis is, however, different. If the QTIP trusts are not drafted properly, the reciprocal trust doctrine could present a significant gift tax risk. The IRS could apply the doctrine for the purpose of arguing that the QTIP election is invalid. Consider the QTIP created by the husband, which requires that income be paid to the wife for life. If, as a matter of substance, the wife is viewed as the grantor of the trust, the election would presumably be disregarded: given the requirement that the grantor's spouse be entitled to the income for life, an election should not be available when the income is payable to the grantor. See T. Herbst, *Lifetime Funding of Reverse QTIP Trusts Enhances GST Planning*, 32 Est. Plan. 28 (2005) (raising a question about the applicability of the reciprocal trust doctrine in the context of lifetime QTIP trusts simultaneously created for the purpose of making an early allocation of GST exemption via reverse QTIP elections). And if the election is disregarded, a taxable gift equal to the entire amount contributed to the trust could result. The reason is the potential application of Code § 2702. That section provides, in general, that when a property owner creates a trust in which he or she has retained the right to income, he or she is deemed to have made a gift of the entire property contributed to the trust because the retention of an income interest may not be subtracted from the value of the property transferred for gift tax purposes. Code § 2702, however, does not apply if the transfer in trust is an incomplete gift in its entirety for federal gift tax purposes. Hence, to ensure that Code § 2702 cannot apply, the QTIP trusts should be drafted to give the beneficiary-spouse a special testamentary power of appointment. That will render both the income interest and the remainder interest incomplete gifts. See Treas. Reg. § 25.2511-2 (indicating that, when the donor retains an income interest and such a special power, the gift is rendered incomplete). And, most important, no adverse estate tax consequence would ensue: if the reciprocal trust doctrine does not apply, then Example 11 to Treas. Reg. § 25.2523(f)-1(f) will foreclose the application of either or both of Code §§ 2036 and 2038; on the other hand, if the QTIP election proves to be invalid on the basis of the reciprocal trust doctrine, the trust actually created by his wife but deemed under the reciprocal trust doctrine as created by the husband for his own benefit would still be included in his estate but under Code § 2036 and/or Code § 2038 rather than under Code § 2044 (with the trust for the benefit of the wife similarly included in her estate on the same rationale rather than under Code § 2044) and it would still use his federal estate tax exemption when he dies survived by his wife. Thus, any gift tax risk that the doctrine poses is easily negated by the special power of appointment without a negative estate tax consequence.

### Reciprocal Trust Doctrine and the Grantor Trust Rules

Although, as suggested, the reciprocal trust doctrine should not create any estate or gift tax threat, the question remains whether it could lead to a problematic denial of grantor trust status. The key to the success of a Supercharged Credit Shelter Trust℠ is that the QTIP created by the surviving spouse constitutes that spouse's grantor trust. Were this to prove not to be the case by reason of the doctrine, the trust would not be supercharged. The income of the credit shelter trust, in other words, would not be attributed to the surviving spouse under the grantor trust rules. If, for example, the wife survived and the husband were viewed, in substance, as the grantor of the QTIP (and the successor credit shelter trust) she had created, its income would not be attributed to her under the grantor trust rules. As a result, if she were to pay the tax generated by the credit shelter trust's income, the payment would constitute a taxable gift. Before turning to the question whether the doctrine can be applied to deny the surviving spouse the desired grantor trust status, it is important to emphasize the absence of any downside risk: if the surviving spouse cannot treat the trust as his or her grantor trust, the only adverse consequence is that its income will remain subject to the DNI rules, which is, of course, the way in which conventional credit shelter trusts are taxed. Thus, if the strategy works, the trust is supercharged; and if it does not, it produces the same outcome as a conventional credit shelter trust. (If the surviving spouse pays the income tax on the trust income because she believes it is a grantor trust for her, but it turns out not to be her grantor trust, Rev. Rul. 2004-64 would not apply to prevent those tax payments from being gifts to the trust. But, if the surviving spouse's powers over the trust include a power to veto distributions to others during her lifetime and a testamentary special power of appointment, those powers would render any gift incomplete, although her powers would cause the portion of the trust attributable to those gifts made by her tax payments to be added back into her gross estate, which is the same result as if she had not made the payments of income tax.)

More important than the absence of downside risk, it would seem that the reciprocal trust doctrine should not result in a failure in the desired grantor trust status. The doctrine has been applied in the context of the grantor trust rules. See *Krause v. Commissioner*, 497 F.2d 1109 (6th Cir. 1974), aff'g 57 T.C. 890 (1972); see also PLR 8813039 (not precedent), applying the reciprocal trust doctrine for grantor trust purposes, which caused the trusts created by a husband and by a wife for each other to be treated as self-settled grantor trusts and thus qualified subchapter S shareholders. The doctrine should not be problematic, however, for lifetime QTIP trusts for two reasons. First, both QTIP trusts are grantor trusts; the only question is whether the husband should be treated as owning the trust he created or the one created by his wife (with a parallel question concerning the wife). This is to be distinguished from *Krause*, in which, absent the doctrine, the IRS would have been unable to characterize either trust as a grantor trust (in *Krause*, the IRS sought to tax the trust's income to one of the spouses). Second, regulations issued in 2000 appear to have abandoned the doctrine for grantor trust purposes. Treas. Reg. § 1.671-2(e)(1) provides: a "person who funds a trust with an amount that is directly reimbursed to such person within a reasonable period of time and who makes no other transfers to the trust that constitute gratuitous transfers is not treated as an owner of any portion of the trust under" the grantor trust rules. Under this regulation, the person who makes the reimbursement is the trust's owner for grantor trust purposes. See Treas. Reg. § 1.671-2(e)(6), ex. 3. Thus, unless the person who creates the trust receives a "direct reimbursement," the creator of the trust is treated as the grantor for grantor trust purposes. In the case of simultaneously created QTIP trusts, no such direct reimbursement occurs. Assuming again that the husband is the surviving spouse, he is treated both before and after his wife's death, under the regulation, as the grantor of the QTIP he had created for her benefit because she did not directly reimburse him. At worst, she might be viewed as having indirectly reimbursed him (by creating the QTIP for his benefit). As a final observation about the regulation, the seeming decision to abandon the doctrine in this context—and thereby narrow the number of cases in which a trust is treated as a grantor trust—is not surprising. After all, at the time this regulation was promulgated, the IRS had already come to fully appreciate the fact that the grantor trust provisions are more helpful than harmful to taxpayers. Lastly, even if the QTIP trusts are deemed reciprocal, it does not necessarily follow that the doctrine applies to the credit shelter trust. Not only is the credit shelter trust a separate and distinct trust created on the death of the spouse first to die (and only one credit shelter trust is created), but at that point, there is no other grantor trust that it could be reciprocal to because the other grantor has died. Therefore, it seems impossible, even if QTIP trusts were treated as reciprocal for grantor trust purposes, to find that the credit shelter trust is reciprocal and thus not a grantor trust for the surviving spouse who created it.

### Why Take *Any* Risk?

Although it seems reasonably clear that simultaneously created QTIP trusts can be used to create a Supercharged Credit Shelter Trust℠ and that the reciprocal trust doctrine does not pose any serious threat to this strategy, it is probably prudent to draft the documents so that there is no risk of failure. This can be accomplished in one of two ways. First, if the remainder interests are not identical, the doctrine may be rendered inapplicable. In *Levy v. Commissioner*, 46 T.C.M. (CCH) 910 (1983), a husband and wife created trusts on the same day, giving each other an income interest. One trust gave the beneficiary-spouse a special power of appointment, and the other did not. As a result of this difference in the terms of the trusts, the reciprocal trust doctrine was not applied. In reaching this result, the court referenced the following language in *Grace*: "The reciprocal trust doctrine does not purport to reach transfers in trust which create different interests and which change 'the effective position of each party vis a vis the [transferred] property . . . .'" Indeed, perhaps, of even greater importance, the IRS had conceded that, if valid, the special power of appointment in the wife prevented the two trusts from being interrelated and, therefore, subject to the reciprocal trust doctrine. Although the IRS contended that the provision creating the special power of appointment was invalid under state law (New Jersey) or otherwise worthless, the court concluded otherwise. It should be noted that the wife's power of appointment was currently exercisable, which is, of course, not permitted in a QTIP trust. Nevertheless, *Levy* does endorse the proposition that, when the trusts have different terms, they are not interrelated and are, therefore, not subject to the reciprocal trust doctrine. And although it is arguable that the Tax Court in *Levy* was wrong in insisting that, under the doctrine, the terms must be identical, see *Estate of Green v. United States*, 68 F.3d 151 (6th Cir. 1995) (Jones, J., dissenting), the IRS has embraced *Levy*. See PLR 200426008 (not precedent). Second, even assuming that the terms of the two trusts are identical, the doctrine should still not apply if they are not created in the same time frame. See *Grace*, 395 U.S. at 316 (emphasizing that the trusts were interrelated because of the parallel terms and because created within a 15-day period).

Thus, to eliminate any risk that the strategy might fail, the trusts should be created at two different points in time (separated by months, not by days as in *Grace*). In addition, they could be drafted differently. So, for example, as in *Levy*, one trust might contain a special power of appointment while the other would not (although, as suggested, it may be preferable to include the power in both trusts to negate any taxable gift should the IRS argue that the QTIP election is invalid, but the power could be exercisable in favor of different classes of appointees and, perhaps, might be exercisable only with the consent of a non-adverse party). One trust might provide that an invasion could only be made after the spouse's other resources are taken into account, while the other might direct that the existence of such resources is irrelevant. Other differences might relate to the income interest. For example, one lifetime QTIP trust might incorporate a unitrust approach but the other would preclude the trustee from using this approach. Also, having different trustees under the two instruments may further help block the application of the doctrine as may funding each trust with different assets and with different values. Given *Grace*, and the Tax Court's application of *Grace* in *Levy*, it would seem that either a difference in timing or a difference in terms should suffice to eliminate the threat of the doctrine. Nonetheless, cautious practitioners may choose to vary both the timing and the terms.

## Lifetime QTIP Trusts and Powers Retained by the Grantor Spouse

As explained above, granting one but only one of the spouses a power of appointment over the successor Supercharged Credit Shelter Trust℠ formed from the lifetime QTIP trust he or she created may be sufficient to vitiate the application of the reciprocal trust doctrine. See *Levy*, 46 T.C.M. (CCH) at 910. As also mentioned, having each spouse retain a power of appointment may prevent certain adverse tax consequences from occurring. But could such a power cause the lifetime QTIP trust to fail to qualify for the gift tax marital deduction?

A nondeductible terminable interest described in Code § 2523(b) may not qualify for the gift tax marital deduction. An interest is a nondeductible terminable interest if the donee spouse's interest is temporary (a life estate, for example) and either, under Code § 2523(b)(1), after that spouse's interest ends someone (including the donor spouse) has an interest in the property or, under Code § 2523(b)(2), the donor spouse has a power to appoint the property. The provision contained in Code § 2523(b)(2) could be construed to mean that a lifetime QTIP trust may not qualify for the marital deduction if the grantor spouse holds a power of appointment over the property in the QTIP trust even if that power is not exercisable or does not take effect until the spouse for whom the QTIP trust was created dies. But the legislative history to the Revenue Act of 1948 (which enacted the marital deduction provisions including the terminable interest rule) suggests that Code § 2523(b)(2) may apply only if the power of appointment the donor spouse holds was granted to him or her by a third party. See, e.g., Senate Finance Committee Report to H.R. 4970, at 1254. Note also that both Treas. Reg. § 20.2041-1(b)(2), as mentioned above, and Treas. Reg. § 25.2514-1(b)(2) suggest that a person cannot create a power of appointment in himself or herself (perhaps reinforcing the notion that Code § 2523(b)(2) can only apply to a power of appointment granted to the donor spouse by a third party), although, as also mentioned above, the spouse for whom the lifetime QTIP trust becomes the transferor of the QTIP property (and, therefore, could grant a general power to the grantor spouse) does not become the transferor until he or she makes a transfer of an income interest during life or until his or her death. In any case, the QTIP regulations at Treas. Reg. § 25.2523(f)-1(a) expressly provide that if the donor retains a power described in Code § 2523(b)(2), no marital deduction is allowable. And that prohibition could encompass a power exercisable only after the donee spouse dies. But at least one commentator has pointed out that makes no sense. J. Pennell, *Estate Tax Marital Deduction*, Tax Mgt. Portfolio No. 843, n.542. Other commentators believe that a lifetime QTIP trust may qualify for the gift tax marital deduction even if the grantor spouse holds a power to control the disposition of the trust property provided the power cannot take effect until the donee spouse for whom the QTIP was created dies. See, e.g., R. Covey, *Marital Deduction and Credit Shelter Dispositions and the Use of Formula Provisions* (United States Trust Company of New York 1999), at 184.

At least two private letter rulings permit the gift tax marital deduction in such a case. PLR 200406004 and PLR 9437032. Although private letter rulings may not, under Code § 6110(f)(3), be cited as precedent, the foregoing rulings are consistent with the legislative history to Code § 2523(f). H. Rep. No. 97-201 to the bill that became the Economic Recovery Tax Act of 1981 (which adopted the QTIP provisions) states, at 161, in part: "[T]he bill permits the creation or retention of any powers over all or a portion of the corpus, provided all such powers are exercisable only at or after the death of the spouse." (This can at found at 1981-2 C.B. 378.) And the so-called Blue Book, the General Explanation of the Economic Recovery Tax Act of 1981, prepared by the Professional Staff of the Joint Committee on Taxation (Dec. 29, 1981), at 235, states: "The Act permits the creation or retention of any powers exercisable in favor of any person over all or a portion of the corpus, provided all such powers are exercisable only at or after the death of the spouse."

Even though, given this history, it is very unlikely that the IRS would (or could) change course and take the position that the grantor of a lifetime QTIP may not retain a power of appointment exercisable only after the donee spouse dies, practitioners may want to consider making any power of appointment retained by the grantor of a lifetime QTIP contingent on its having no effect on the validity of the QTIP election or marital deduction qualification. Here is a sample provision to be added to the provisions of any trust (such as the Supercharged Credit Shelter Trust℠ and any QTIP trust created for the grantor spouse on the death of the donee spouse for whom the lifetime QTIP trust was created):

> The balance of the property then held in the Trust, upon the Grantor's death, shall be disposed of as follows: (a) to the extent but only to the extent that the Grantor's holding a power to direct the distribution of the balance of the property does not or would not cause any property transferred by the Grantor to the Lifetime QTIP Trust hereunder to fail to qualify, in whole or in part, for the Federal gift tax marital deduction pursuant to Code Sec. 2523(f), such balance shall be distributed to such persons out of a class composed of my descendants [modify the class description as appropriate], on such terms as the Grantor may appoint by a Will or other signed writing that is acknowledged by the Grantor before a notary public specifically referring to this power of appointment and delivered to the Trustee of this Trust; or (b) if the Grantor has no power of appointment because the conditions of clause (a) of this sentence are not satisfied, or, in default of appointment, or insofar as the appointment is not effective, [specify alternative disposition such as into per stirpital shares for descendants].

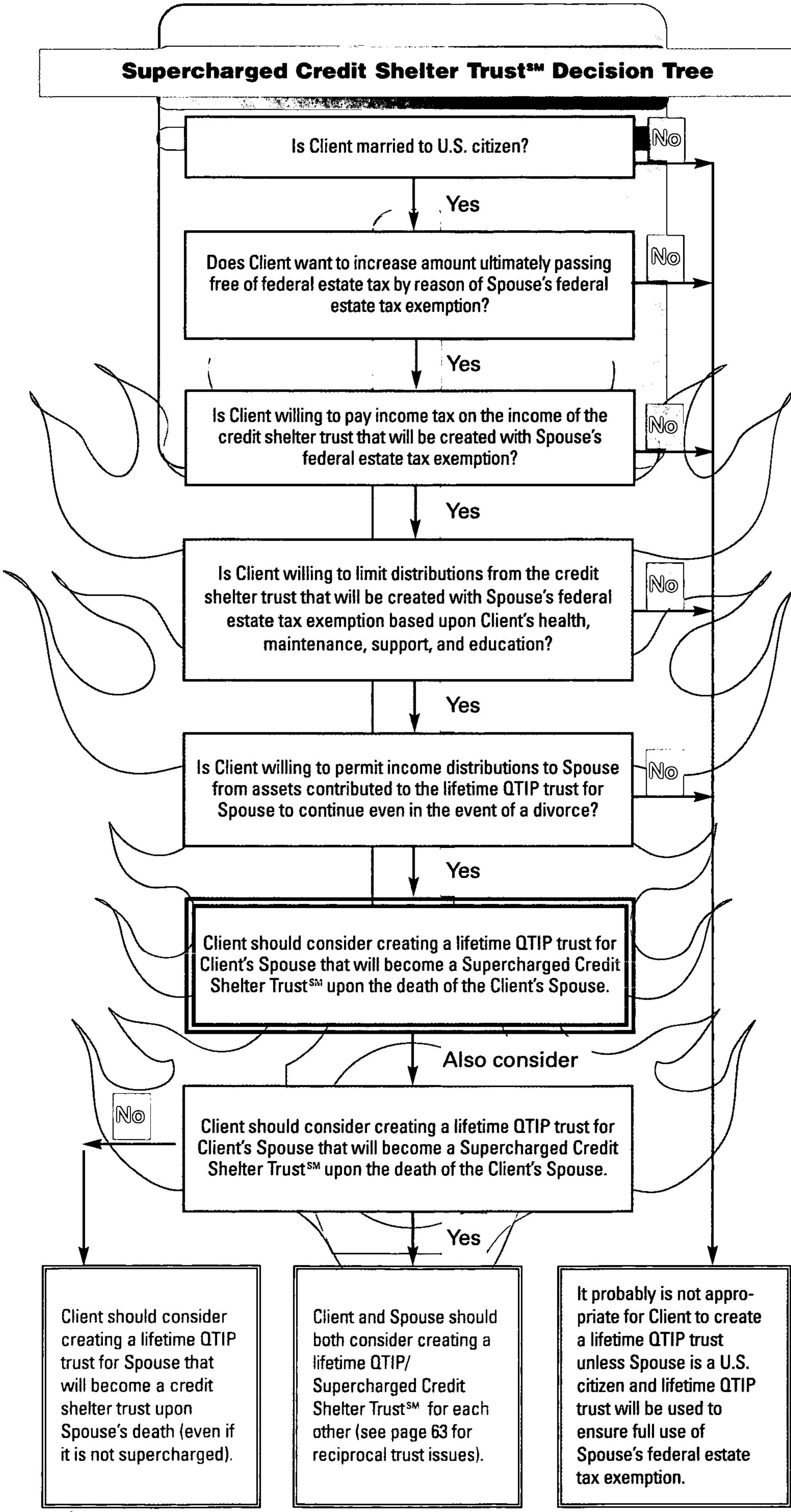
### Income Tax Basis Matters

When the spouse for whom the lifetime QTIP trust is created dies, the trust will be included in his or her estate under Code § 2044. The income tax basis of property that is included under Code § 2044 is changed to its estate tax value under Code § 1014(a). See Code § 1014(b)(10). Ordinarily, in the case of a grantor trust, the grantor is deemed to own the trust's assets. See Rev. Rul. 85-13, 1985-1 C.B. 184. As a consequence, one might question whether the grantor-trust rules or Code § 1014(b)(10) should control. In other words, if, as suggested, the trust is treated as the grantor trust of the grantor spouse, does Rev. Rul. 85-13 preclude any change in basis at the death of the donee spouse on the theory that the assets were owned by the grantor for income tax purposes at all times? It would seem that the specific provision in Code § 1014(b)(10) should control. Indeed, in all lifetime QTIP trusts, the trust is deemed the grantor spouse's grantor trust. See Code § 677. And Code § 1014(b)(10), in providing for a basis adjustment in the case of all QTIPs, clearly does not contemplate an unstated exception for lifetime QTIPs.

The fact that the credit shelter trust is supercharged—that is, that it remains a grantor trust until the grantor of the lifetime QTIP trust dies—offers another potential benefit for change in basis. In effect, unlike a conventional credit shelter trust, a Supercharged Credit Shelter Trust℠ creates an opportunity to change basis under Code § 1014 at the surviving spouse's death as well. Because the credit shelter trust for the grantor spouse is a grantor trust, before the grantor spouse dies, he or she may exchange, income tax free under Rev. Rul. 85-13, high-basis assets (such as cash) for low-basis assets in the trust. The low-basis assets the grantor receives from the trust will have their bases changed to the extent provided under Code § 1014(a); and the high basis in the assets transferred into the Supercharged Credit Shelter Trust℠ will carry over even after the grantor spouse dies. That result cannot be accomplished with traditional credit shelter trusts. See also J. Blattmachr, M. Gans & H. Jacobson, *Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death*, 97 J. Tax'n 149, at 154–59 (Sept. 2002).

### More Drafting Tips

As explained at the beginning of this article, the will or revocable trust of a married person who wants to effectuate a "optimal" marital deduction estate plan sets aside the amount sheltered by the unified credit into a credit shelter trust and has the balance pass in a form that will qualify for the marital deduction. That is normally accomplished either by a word formula that defines the credit shelter (or estate tax exemption) amount or, conversely, by a word formula that defines the minimum amount necessary to qualify for a marital deduction to reduce the federal




estate tax to its minimum. These word formulas almost always take into account other assets that are included in the married person's estate and that use part or all of the deceased spouse's estate tax exemption. Hence, by way of example, if the spouse dying first owns property with rights of survivorship with a sibling, the credit shelter amount under the will or revocable trust will be reduced to the extent that joint property is included in the spouse's estate. See Code § 2040. The word formula in the will or revocable trust also will take into account any property included in the spouse's estate under Code § 2044 (that is, a QTIP trust that has been created for that spouse by his or her surviving spouse or a prior spouse) that does not qualify for the estate tax marital or charitable deduction on the beneficiary spouse's death.

If supercharging the credit shelter trust is desirable, such word formulas will help achieve that goal by having the unified credit of the spouse dying first applied to the assets in the lifetime QTIP trust that has been created for that spouse because the lifetime QTIP will be a grantor trust for the surviving spouse, as explained above. But word formulas must be used to define the credit shelter amount (or, conversely, the minimum marital deduction) under the lifetime QTIP trust document as well as in the deceased spouse's will or revocable trust. These definitions may be similar to the word formulas used in a married person's will or revocable trust but need to be refined to exclude any word formula definition dispositions in the will or revocable trust of the spouse who was the beneficiary of the lifetime QTIP trust. Here are some examples of possible definitions to use in the lifetime QTIP trust to have the unified credit of the donee spouse who was the beneficiary of the lifetime QTIP trust used first under that document:

> If the Grantor survives the Grantor's spouse, the Trustee of the Lifetime QTIP trust shall transfer from the Lifetime QTIP Trust a sum/fractional share equal to the Grantor's spouse's Estate Tax Exemption to the Trustee of the Credit Shelter Trust under this Agreement, to be disposed of under the terms of that trust. The Grantor's spouse's "Estate Tax Exemption" means

the largest amount (but not taking into account any disposition made under the Grantor's spouse's Will or any revocable trust created by the Grantor's spouse that purports to be specifically based upon the use of the amount of the Grantor's spouse's remaining unified credit, applicable exclusion amount, estate tax exemption amount, or similar tax-driven formula amount, including but not limited to pursuant to a so-called optimum marital deduction disposition, unless the provisions of any such Will or revocable trust expressly and by express reference supercede the provisions of this Agreement providing for the creation of the Credit Shelter Trust) that can pass to the Credit Shelter Trust hereunder without increasing the Federal estate tax in the Grantor's spouse's estate. It is the Grantor's intent by this provision for the Grantor's spouse's available applicable exclusion amount to be first used to fund the Credit Shelter Trust hereunder before being used to fund any disposition based upon the Grantor's spouse's applicable exclu-

## Avoiding Possible Applications of the Reciprocal Trust Doctrine If Each Spouse Will Create a Lifetime QTIP Trust (LQT) That Will Become a Supercharged Credit Shelter Trust℠ [1]

**Client's LQT for Spouse**

1. Create currently
2. Permit income interest to be converted to unitrust[2]
3. Spouse may withdraw for HEMS[3]
4. Spouse has testamentary SPA[4] among broad class (without anyone's consent)

**Spouse's LQT for Client**

1. Create about one year after Client's LQT for Spouse (with different assets with different values and with different trustees)
2. Prohibit conversion of income interest to unitrust
3. No lifetime withdrawal power
4. Client has testamentary SPA among narrow class (exercisable only with consent of non-adverse party)

Upon Death of First to Die of Client or Spouse

**Supercharged Credit Shelter Trust℠ for Client[5]**

1. Client can veto distributions to other trust beneficiaries
2. No lifetime withdrawal power
3. Client has no lifetime SPA
4. Client has testamentary SPA among narrow class (exercisable only with consent of non-adverse party)

OR

**Supercharged Credit Shelter Trust℠ for Spouse[5]**

1. Spouse can veto distributions to other trust beneficiaries
2. Spouse may withdraw for HEMS[3]
3. Spouse has lifetime SPA
4. Spouse has testamentary SPA among broad class (without anyone's consent)

**Balance in QTIP Trust for Client[5]**

1. Prohibit conversion of income interest to unitrust
2. No lifetime withdrawal power
3. Trustee distributions to Client limited by HEMS standard
4. Client has testamentary SPA among narrow class (exercisable only with consent of non-adverse party)

OR

**Balance in QTIP Trust for Spouse[5]**

1. Permit income interest to be converted to unitrust[2]
2. Spouse may withdraw for HEMS[3]
3. Trustee distributions to Spouse limited by HEMS standard
4. Client has testamentary SPA among broad class (without anyone's consent)

1. A strong argument can be made that the reciprocal trust doctrine should not apply at all. The structure suggested represents a conservative approach.
2. Condition on state law permitting such conversion.
3. HEMS means health, education, maintenance, and support. Consider whether right of withdrawal will allow Spouse's creditors to attach trust assets. If that is a concern, do not grant the withdrawal power.
4. SPA means special power of appointment.
5. Note that upon the death of the first of Client and Spouse to die, only one Supercharged Credit Shelter Trust℠ will be created (limited to the unused estate tax exemption of whichever of Client and Spouse dies first), which will be for the survivor of Client and Spouse, with any balance in the LQT passing into a QTIP trust (or other form of marital deduction transfer) for the survivor of Client and Spouse.

sion amount under the Grantor's spouse's Will or any revocable trust created by the Grantor's spouse; provided, however, that the Will or any revocable trust created by the Grantor's spouse does not contain an express direction to the contrary referring specifically to this Agreement and the Credit Shelter Trust created hereunder.

The definition raises an interesting question: can the surviving spouse "steal" the unified credit (and GST exemption) of his or her spouse? In other words, by having the grantor spouse of the lifetime QTIP trust define the credit shelter amount without regard to any credit shelter disposition contained in his or her spouse's will or revocable trust, will that foreclose the spouse who is the beneficiary of the lifetime QTIP trust from using his or her unified credit under his or her will or revocable trust? Let's take an example. John and Maria are married but have children from prior marriages. Maria is likely to die before John. John creates a lifetime QTIP trust for Maria that will convert into a Supercharged Credit Shelter Trust℠ for him when Maria dies. John structures the lifetime QTIP trust for Maria so that the credit shelter trust amount in the lifetime QTIP trust is determined without regard to any disposition Maria makes of it under her will or revocable trust. Maria is willing to have any amount in her estate above her credit shelter amount pass into a QTIP trust for John to postpone estate taxation until his death, when the property in that QTIP trust will pass to her descendants. But she wants to have the credit shelter amount pass to her descendants when she dies and her will so provides. If her will is structured so the credit shelter trust amount is defined by taking into account all other dispositions of assets included in her gross estate (such as property she jointly owns with her brother or any QTIP trust included in her estate under Code § 2044), her desire to benefit her descendants with her unified credit will fail: the unified credit will be used first under the lifetime QTIP trust for John and ultimately his descendants.

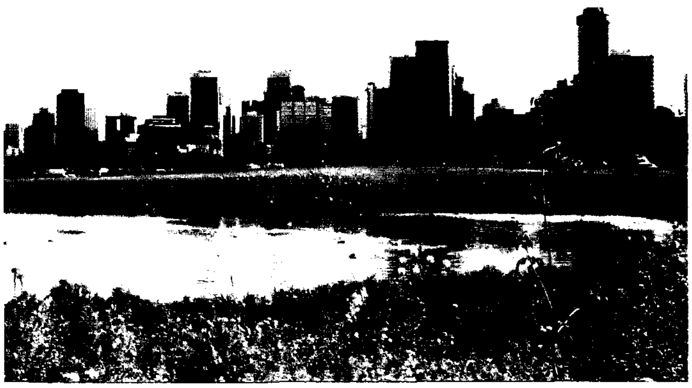
This suggests a need for careful coordination between the lifetime QTIP trust and the will or revocable trust of the spouse who is the beneficiary of the lifetime QTIP trust. For example, if Maria is aware of the lifetime QTIP trust John has created for her (and one would think she would be) and its terms (and one would hope she or her counsel would be), then she can define the credit shelter amount to pass to her descendants under her will (or revocable trust) without taking into account the disposition in the lifetime QTIP trust that otherwise would use up her unified credit. In other words, there will be a disposition equal to the credit shelter amount in both the lifetime QTIP trust and her will (or revocable trust). That means there will be estate tax. For example, if Maria dies in 2007 with her entire $2 million estate tax exemption available, a $2 million credit shelter trust will be created for John (passing on his death to his descendants) under the lifetime QTIP trust he created for Maria and a $2 million bequest (also equal to Maria's unused estate tax exemption) will be made under Maria's will or revocable trust to her descendants. Because neither of these dispositions qualifies for the marital (or charitable) deduction, Maria will have a $4 million taxable estate and federal (and, perhaps, state) estate tax will be payable. Who bears the burden of that tax? Unless Maria has specifically directed otherwise, the burden of the federal tax will be borne, under Code § 2207A, by the property in the lifetime QTIP trust. (Code § 2207A directs that the marginal increase in federal estate tax attributable to the inclusion under Code § 2044 in the decedent's estate of a QTIP trust must be borne by the QTIP trust except to the extent that the decedent in his or her will, or a revocable trust, specifically indicates an intent to waive the right of recovery.) Hence, it is likely that John's attempt to "steal" Maria's unified credit will fail at least for federal estate tax. But if Maria's estate is also subject to state estate tax, that tax may not be borne exclusively by the lifetime QTIP trust unless state law provides otherwise (see, e.g., N.Y. Est. Powers & Trusts Law § 2-1.8(d)) or, perhaps, if Maria's will or revocable trust so provides. The suggested language above would avoid the creation of two credit shelter trusts by permitting any creation of a credit shelter trust under the donee spouse's will or revocable trust that expressly provides that it supercedes the creation of the credit shelter trust under the lifetime QTIP to control.

Presumably, in many cases, the spouses will work together to allow a Supercharged Credit Shelter Trust℠ to be created for the surviving spouse. That means a "standard" word formula will be used in the will or revocable trust of the spouse who was the beneficiary of the lifetime QTIP trust so his or her unified credit will be used under the will (or revocable trust) only to the extent there is insufficient property in the lifetime QTIP trust fully to use the unified credit.

## Summary and Conclusions

Given the additional wealth the Supercharged Credit Shelter Trust℠ provides for descendants, as compared to the amount of wealth provided under a conventional credit shelter trust, it probably should be considered in all cases in which the spouses have sufficient net worth. Although the reciprocal trust doctrine may be perceived as posing a threat to the viability of the strategy, with proper drafting it does not create any additional estate or gift tax risk, it poses no downside risk for income tax purposes, but, most important, the application of the doctrine may be effectively avoided by varying the timing and provisions of the two trusts. Thus, the strategy provides a sound means significantly to enhance the effectiveness of the federal estate tax exemption of the spouse dying first and, through reverse QTIP elections for each lifetime QTIP trust at the time each is created, the GST exemptions of both spouses. ■

# U P C O M I N G



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To find out more information on future topics and dates, please visit the calendar section on our web site at **www.abanet.org/rppt**.

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