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Settling the Estate of a Married Individual with a Credit Shelter Trust

Married couples with estates in excess of \$2 million often have so-called Credit Shelter Trusts in place, with the goals of 1) avoiding the probate process at the death of each spouse and 2) reducing or eliminating estate taxes at the second spouse's death.

Credit Shelter Trusts are based upon the fact that, with a married couple, estate taxes are not calculated and/or due until the death of the second spouse. A typical couple holds all assets jointly (real estate, bank accounts, investment accounts) or each spouse has the other as named beneficiary (retirement accounts and life insurance). When the first spouse dies, all assets pass directly to the surviving spouse. Then, when the second spouse dies, if his or her estate is \$2 million or less, no estate taxes are due. However, if the second spouse's estate exceeds \$2 million, Massachusetts imposes an estate tax on what exceeds \$2 million. At the federal level, estate taxes are imposed only on assets exceeding \$13.99 million per individual (and married couples can exempt \$27.98 million).

Credit Shelter Trusts allow a married couple to have up to \$4 million and reduce, if not eliminate, the estate tax that would otherwise be due at the death of the second spouse. The trusts work as follows: each spouse has his or her own trust and, during life, directs assets to that trust, by making trusts the owner or beneficiary of various assets. For example, titles to real estate, bank accounts, and investment accounts will be divided equally (1/2 in each spouse's trust) and assets held in only one spouse's name (life insurance or non-qualified annuities) will designate the owner's trust as beneficiary. The goal is to direct assets to trust, rather than to the surviving spouse, and to do so as equally as possible, since we do not know which spouse will die first. Retirement accounts (IRAs, 401k, etc.) typically continue to have the spouse as primary beneficiary and the account owner's *Family Trust* as contingent beneficiary, which ensures that the surviving spouse will have the option to stretch out the required minimum distributions after the owner spouse's death.

When the first spouse dies, any assets in the name of or directed to that spouse's trust, up to \$2 million, will be held in a Credit Shelter sub-trust and not be counted in the estate of the second spouse to die. The result is that the second spouse's estate will be less and, commensurately, the estate tax will be less. If the first spouse to die has sufficient assets to reduce the second spouse's estate to less than \$2 million, there will be no estate taxes assessed at the second spouse's death. The most that can be removed from the second spouse's taxable estate (at the first spouse's

death) is \$2 million, so if the first spouse to die has *more than* \$2 million in his or her trust, the overage will be included in the surviving spouse's estate at his or her death.

For example, if a married couple is worth \$2.6 million and died without Credit Shelter Trusts, the Massachusetts estate tax would be approximately \$70,000. If, however, the first spouse to die had assets in his or her trust of at least \$600,000, this might reduce the value of the second spouse's estate to under \$2 million, thus avoiding the entire tax. If the first spouse to die, in fact, has less than \$600,000 in his or her trust or the surviving spouse's estate grows beyond \$2 million, there would be an estate tax at the second spouse's death (but less, because of the assets excluded at the first spouse's death).

With careful consideration of estate, income, and capital gains taxes, it is often possible to reduce the second spouse's estate to less than \$2 million prior to his or her death (a "second bite at the apple"). Any gifting during the second spouse's life should be done in consultation with an experienced elder law attorney (with regard to the impact on potential MassHealth eligibility) and competent tax advisor, to ensure that the carry-over basis for appreciated assets gifted do not result in capital gains taxes that are greater than the estate taxes would have been if the assets had remained in the decedent's estate. Capital gains tax rates, although only on an asset's increase in value since purchase, are higher than estate tax rates, which are assessed on the entire value of an asset.

If the first spouse to die held *greater than* \$2 million in the name of his or her trust, \$2 million is carved out, remaining in trust, and the excess is included in the value of the second spouse's estate. Removing \$2 million from the second spouse's estate typically results in a savings of between \$75,000 and \$200,000, depending upon the value of the estate. Again, with careful planning, it might be possible to reduce the surviving spouse's estate to further decrease or even eliminate estate taxes which are ultimately owed.

In our office, each spouse actually has two trusts – a Credit Shelter Trust, which we call a "Family Trust," and a nominee trust, which we call an "Investment Trust," for a total of four trusts. The sole purpose of the *Investment Trusts* (the public trusts) is to protect the privacy of the *Family Trusts* (the private trusts), which contain the estate-tax savings language and details about how assets will be distributed at the second spouse's death (details which would otherwise be included in a Will, for individuals who elect not to execute trust documents). Each spouse's *Family Trust* is the beneficiary of that spouse's *Investment Trust*, as reflected on a Schedule of Beneficial Interests (this connects the two trusts, as "the *Family Trust* is 100% beneficiary of the *Investment Trust*"). This allows our clients to use the *Investment Trusts* (containing mostly-administrative provisions) with various financial institutions, keeping the contents of the *Family Trusts* private. We reinforce this distinction by putting post-it notes on the trusts: the ones for the *Family Trusts* are red and say, "PRIVATE," and the ones on the *Investment Trusts* are green and say, "PUBLIC."

We typically name each spouse as Trustee of his or her own trusts while alive, and then the surviving spouse as Successor Trustee, after death. If the surviving spouse is unable to serve or not interested in serving, there are usually three or four alternate individuals named.

Because the surviving spouse's taxable estate will include all assets over which he or she had complete control at the time of death, the terms of the first spouse's trust include limiting language (called an "ascertainable standard") to ensure that, just because the surviving spouse can access funds in the first spouse's Credit Shelter Trust, those assets will not be included in the surviving spouse's estate for tax purposes. The language says that the Successor Trustee (the spouse) can access funds for "medical expenses and support in the standard of living to which the Donor's spouse had become accustomed at the time of the Donor's death." This is very broad and typically means that, although the surviving spouse should avoid dipping into the assets in the first spouse's Credit Shelter trust, since they are protected, if the surviving spouse's estate is comfortably under a \$2 million, he or she could withdraw funds, so long as the funds are spent promptly or will not result in the surviving spouse's estate exceeding \$2 million at death.

When the first spouse in a married couple with Credit Shelter Trusts dies:

- 1) The first step is to determine what assets are either in the name of the deceased spouse's *Investment Trust*, or which name the *Investment Trust* as beneficiary. This determines whether the entire amount will be removed from the surviving spouse's estate (if it is under \$2 million) or whether some (whatever is over \$2 million) will be included in the surviving spouse's estate.
- 2) If the only asset(s) in the name of the first spouse's trust is/are real estate, there is no need to obtain a tax identification number (EIN) until the property is sold.
- 3) If there are non-real estate assets in trust or which name the trust as beneficiary (bank accounts, investment accounts, shares of stock, life insurance), the Successor Trustee (usually the surviving spouse) must apply for an EIN for the deceased spouse's *Investment Trust* at www.irs.gov (**directions are at our website**), before approaching the relevant financial institutions.
- 4) If there is real estate, the Successor Trustee should execute an Acceptance of Appointment as Successor Trustee (**sample may be found at our website**), to formalize the role. This should be recorded at the Registry of Deeds, along with the deceased spouse's Certificate of Death and, if sale of the property will occur within ten years of death, an Affidavit Regarding Estate Taxes (see below). These items may be recorded immediately or wait until sale of the property. They simply need to happen before the Trustee has good title to convey/sell the property.
- 5) Where there are assets titled in trust or which name the trust as beneficiary, some financial institutions may want a formal Acceptance of Trustee, while others will rely on the terms of the trust and the death certificate. **We have sample forms at our website.**
- 6) In order to access the non-real estate assets in trust, the successor Trustee will need to present the assigned EIN, a certified copy of the deceased spouse's death certificate (a photocopy, with raised seal), and a copy of the trust, reflecting the Successor Trustee's nomination. Some financial institutions will have additional company-specific forms for the Successor Trustee to sign.
- 7) Assets titled in trust or which name the trust as beneficiary will not be accessible until the Successor Trustee presents the above items. Once accepted by the financial institutions, the current account(s) will be closed and new accounts will be opened in the name of the

deceased spouse's *Investment Trust*, reflecting the Successor Trustee's name (assets are not liquidated – just moved in-kind).

- 8) If the value of all assets directed to the deceased spouse's trust (including real estate) exceeds \$2 million, the Trustee should work with a competent tax advisor to select which assets should "fund" the \$2 million Credit Shelter Trust and which will be distributed to the surviving spouse, knowing they will be taxed at the death of the surviving spouse. Some assets may be expected to continue increasing in value and estate taxes versus capital gains taxes will need to be weighed in determining which should comprise part of the \$2 million and which should become part of the surviving spouse's taxable estate.
- 9) Regardless of the value of the estate, the Successor Trustee should sign an Amended Schedule of Beneficial Interests, clarifying that all assets remaining in the deceased spouse's trust are to be directed to the Credit Shelter portion of the deceased spouse's trust (the original Schedule names the general *Family Trust* as beneficiary).
- 10) All assets in the deceased spouse's name/trust receive a stepped-up basis, meaning that capital gains upon sale will be calculated using the date-of-death values (the basis is re-set). This can be beneficial for assets which had appreciated significantly during the deceased spouse's life and can now be sold with minimal or no capital gains tax due. However, if the assets continue to be held and grow in value, there will likely be a capital gains tax upon sale during the surviving spouse's life.
 - Assets held in the \$2 million Credit Shelter Trust do not get a second step-up at the surviving spouse's death. The ultimate beneficiaries of the trust assets will have to use the values on the first spouse's date of death when calculating gain and capital gains taxes.
 - Assets which pass directly to the surviving spouse will be stepped up again at the second spouse's death (the result of being included in the taxable estate).
 - If there is a significant increase in the market value of assets which were in the deceased spouse's trust, it may be beneficial, in some cases, to move them to the surviving spouse, even if estate taxes will be due. This must be done carefully and with expert advice, to ensure that there will be tax savings.
- 11) Once the assets have been allocated (all or a portion) to the Credit Shelter sub-trust, a second round of accounts will need to be opened, moving assets from the *Investment Trust* to the Credit Shelter sub-trust. The Trustee needs to apply for a second EIN and complete paperwork to move assets from the *Investment Trust* account(s) to new accounts in the name of the Credit Shelter Trust.
 - It may feel like a lot of work, but it is far less than if Probate Court proceedings were necessary and the estate tax savings are significant: these are the assets which will be excluded from the value of the surviving spouse's taxable estate.
- 12) In the year of the decedent's death, the Trustee will need to file up to three sets of income tax returns, depending upon the timing of the deceased spouse's death and the income earned from the trusts:
 - Form 1040 individual income tax returns (likely jointly with the surviving spouse);
 - Form 1041 fiduciary income tax returns for the short-lived *Investment Trust* (the first account established after the deceased spouse's death), but only if income exceeds the tax-filing thresholds (gross income of \$200 for Massachusetts and \$600 for federal); and/or

- Form 1041 fiduciary income tax returns for the newly-created Credit Shelter Trust, again, only if the income exceeds the filing thresholds.
 - While the surviving spouse will continue to file his or her own personal returns and the Credit Shelter Trust will need to keep filing returns, the return for the *Investment Trust* should be one-time only.
 - Most accountants will likely have any income earned by the ongoing Credit Shelter Trust paid out to the surviving spouse, so that it can be taxed at his or her lower income tax rate.
- 13) All assets paid out to the surviving spouse (because they exceed the \$2 million Credit Shelter amount or because the surviving spouse took them from the Credit Shelter amount) should be deposited into accounts that are, ideally, in the individual name of the surviving spouse, with that spouse's *Investment Trust* as beneficiary. Otherwise, they should be in accounts owned by the surviving spouse's *Investment Trust*. The goal is to similarly avoid the need for Probate Court proceedings at the death of the second spouse.
- 14) The surviving spouse should revisit beneficiary designations on his or her non-retirement assets, to ensure they correctly designate the surviving spouse's *Investment Trust*. Retirement accounts - whether inherited from the deceased spouse or already owned by the surviving spouse - may need new beneficiaries, as well. If the surviving spouse does not have a standard distribution to children, and/or one or more should not inherit directly (for example, one is a minor or has health or financial issues warranting that their share be managed in trust), this might be the surviving spouse's *Family Trust* as sole beneficiary. If the surviving spouse has standard distribution to individuals (children or other adults), all of whom can safely inherit directly, then it might be appropriate to list the surviving spouse's *Family Trust* as primary beneficiary, and the individuals as contingent beneficiaries (this allows the successor Trustee of the second spouse's trust to elect that funds are paid to the *Family Trust* or directly to the named individuals, depending upon whether any of the *Family Trust* contingency provisions are appropriate). This should be carefully considered with a professional.

ACTION CHECKLIST:

- ❑ Determine what assets are titled in the name of the deceased spouse's *Investment Trust*;
- ❑ Determine what assets are titled in the deceased spouse's individual name, but have the deceased spouse's *Investment Trust* as beneficiary;
- ❑ Determine whether any assets were in the deceased spouse's individual name, but had no joint owner or beneficiary - these assets will require Probate Court proceedings, but will end up in the deceased spouse's trust (assets that go through court are directed to the deceased spouse's *Family Trust*);
- ❑ **Do not access/withdraw/liquidate any assets in or directed to the deceased spouse's *Investment Trust*, until it is clear which assets will remain in trust and which, if any, will be paid out to the surviving spouse. Once assets are removed from the deceased spouse's trust, they cannot be put back in;**
- ❑ Obtain an EIN (tax identification number) to access assets held in the name of the *Investment Trust* or which name the *Investment Trust* as beneficiary (they cannot be accessed without this);

- ❑ The named Successor Trustee (if willing to serve) should sign Acceptances of Appointment for the *Investment Trust* and the *Family Trust*, as well as a modified version of Appointment for the *Investment Trust*, suitable for recording at the Registry of Deeds, if the trust has an interest in real estate;
- ❑ Determine the total value of the deceased spouse's estate, including assets held jointly with the surviving spouse and anyone else – if the value of assets belonging solely to the deceased spouse (including those titled in trust or which named a trust as beneficiary), plus 100% of the value of assets held jointly with a non-spouse and ½ the value of assets held jointly with the surviving spouse exceed \$2 million, a Massachusetts estate tax return must be filed, although, in most cases, no estate tax will be due;
- ❑ Determine the total value of the assets held in the name of the deceased spouse's *Investment Trust* or which name the *Investment Trust* as beneficiary (i.e., not the value of assets held jointly with someone else, including the surviving spouse);
- ❑ If the trust assets total *less than* \$2 million, all should be transferred to a new account or accounts, titled as follows, “**John Doe, [Successor] Trustee, Doe Article ____ [Article number in *Family Trust* establishing the Credit Shelter Trust] Credit Shelter Trust, udt dated _____.**” The Trustee will use the assigned EIN when opening accounts.
- ❑ If the trust assets total *greater than* \$2 million, the surviving spouse should work with a professional (CPA and/or attorney) to allocate the first \$2 million in assets to remain in trust, with the excess paid out/transferred to the surviving spouse (who will want to be sure to either title them in the name of the surviving spouse's Investment Trust or designate either the surviving spouse's Investment Trust or Family Trust, as appropriate, as beneficiary. The allocation should take place as soon as possible after the deceased spouse's death and, for sure, no later than nine (9) months after death. Assets remaining in the deceased spouse's trust should be transferred to a new account or accounts, titled as follows, “John Doe, [Successor] Trustee, Mary Doe [deceased spouse] Investment Trust, udt dated _____.” The Trustee will use the assigned EIN when opening accounts.
- ❑ Once it is determined which assets will remain in the deceased spouse's trust, the Trustee should execute an Amended Schedule of Beneficial Interests (replacing the one signed by the deceased spouse) to reflect that the assets remaining in trust are directed, specifically, to the so-called Credit Shelter Trust contained in the deceased spouse's Family Trust (this is the trust that holds assets which will not be included in the value of the surviving spouse's estate).
- ❑ File income tax returns each year the deceased spouse's trust remains funded. Income, including dividends, interest, and rental proceeds, as well as capital gains, can flow through to the surviving spouse, so that they can be reported on the surviving spouse's person income tax returns and taxed at a lower rate (trusts are subject to higher tax rates).
- ❑ Monitor the value of both assets held in both the deceased spouse's trust and the surviving spouse's trust. There may be circumstances when it would save capital gains or estate taxes to shift some of the assets in the deceased spouse's trust to the surviving spouse. This should be explored with an experienced CPA, as it involves analyzing the growth of the assets held in the deceased spouse's trust and the total value of the surviving spouse's taxable estate.