Since 1981, a person can pass any size estate to his/her spouse without estate taxes because of the unlimited marital deduction. However, when the surviving spouse dies, any amount in excess of his/her estate tax exemption is subject to estate taxes. Therefore, the estate tax exemption of the first spouse to die is wasted.

Under the Tax Relief Act of 2010, the estate and gift tax exemption is $5 million per person with a top tax rate of 35%. The exemption is adjusted for inflation beginning in 2012. However, without further Congressional action, on January 1, 2013, the estate and gift tax exemption decreases to $1 million per person, and the top tax rate increases to 55%.

To preserve the estate tax exemption of the first spouse to die, many couples use a living trust. When the first spouse dies, an amount equal to his/her estate tax exemption is placed into a credit shelter trust (also called a “family” or “residuary” trust). The credit shelter trust is not taxed at either spouse’s death. Yet, during the surviving spouse’s lifetime, the surviving spouse (and his/her descendants) can access the income and principal of the credit shelter trust (if necessary) for their health, education, maintenance and support.

Ideally, each spouse’s living trust should be funded with an amount equal to the estate tax exemption. Otherwise, all or a portion of the exemption will be wasted. However, in many situations it is difficult to divide a couple’s assets in such a way to take advantage of each spouse’s estate tax exemption. For example, you generally do not want to use qualified retirement plan assets or IRAs to fund a credit shelter trust, because this will likely result in shortening the income tax deferral period of the plan or IRA. Perhaps it is the couple’s second marriage, and the wealthier spouse is reluctant to transfer assets to his/her spouse. Likewise, maybe one of the spouses is susceptible to liability claims (i.e. a physician) and, therefore, is reticent to have assets in the name of his/her living trust.

Of course, if we had a “crystal ball” and knew who would die first, it would be easy to plan for that. Fortunately, in recently issued Private Letter Ruling 200604028 (the last in a series of similar rulings), the IRS basically blessed a technique that works almost as well as the “crystal ball.” In essence, this technique allows a credit shelter trust to be funded with the same pool of assets, regardless of which spouse dies first. The IRS allowed the estate tax exemption of the first spouse to die to shelter assets the surviving spouse had placed in a living trust.

The husband created a living trust and funded it with his separate assets. He gave his wife a testamentary general power of appointment over a portion of the trust’s assets. The portion subject to the general power was equal to the estate tax exemption, less the value of the wife’s separate assets. The wife could exercise the power of appointment in favor of her estate only if she died first. In turn, her estate plan provided that her own assets, plus the assets subject to the power of appointment, flowed into a credit shelter trust for the benefit of her husband (the wealthier spouse) and their descendants. In structuring this estate plan, the couple used a single pool of assets to fund a credit shelter trust, regardless of which spouse died first. The ruling concluded that the credit shelter trust would not be included in the husband’s estate, even though the assets originally came from him.

To illustrate, John and Mary have a net worth of $10 million – $5 million in John’s IRA rollover and $5 million in jointly-titled assets (i.e. residence,
vacation home, cash and securities). John names Mary as the beneficiary of his IRA so that she can roll over the IRA and thereby “stretch” the payments over the longest period of time. Since John has the shortest life expectancy, the other $5 million of assets are titled in the name of his living trust. If John dies first, his $5 million estate tax exemption will be fully utilized in his credit shelter trust while preserving the IRA rollover. If Mary dies first, she will exercise her testamentary power of appointment so that $5 million of assets in John’s living trust are pulled into her living trust to fund her credit shelter trust.

Alternatively, if John were a physician concerned about malpractice liability, the $5 million of non-retirement plan assets could be titled in Mary’s living trust. The retirement plan assets are not attachable by creditors under state and federal law. John will name Mary as the direct beneficiary of his IRA. In this situation, Mary would give John the testamentary general power of appointment to “pull” $5 million of the assets in her living trust into his living trust to fund his credit shelter trust. Of course, during any period in which John has a potential malpractice claim, Mary would amend her living trust so as to eliminate the power of appointment. Otherwise, the assets brought into John’s living trust by exercise of the testamentary general power of appointment could be attachable by his creditors.

**Portability**

Generally, prior to the Tax Relief Act of 2010, a married couple had to use a credit shelter trust to utilize both spouses’ estate tax exemptions. However, for married persons who both die in 2011 or 2012, the executor of the estate of the predeceased spouse can “transfer” any unused estate tax exemption to the surviving spouse (on a timely-filed estate tax return - Form 706). To prevent “serial marriages”, only the most recently deceased spouse’s unused exemption may be transferred to the surviving spouse. This new law is referred to as a “portability” provision.

Despite the relative simplicity of just letting the surviving spouse use the predeceased spouse’s unused estate tax exemption in 2011 and 2012, there are several reasons for still using a credit shelter trust in lieu of portability, including the following:

- The predeceased spouse’s unused exemption is not indexed for inflation.
- The first predeceased spouse’s unused exemption will be lost if the surviving spouse remarries and survives his/her next spouse.
- The appreciation in the assets in the credit shelter trust is removed from the surviving spouse’s estate.
- The predeceased spouse (as opposed to the surviving spouse) controls the management and distribution of the assets in the credit shelter trust.
- There is no transfer to the surviving spouse of the predeceased spouse’s unused generation-skipping transfer tax exemption.
- The portability provision sunsets on December 31, 2012.

**Summary**

A private letter ruling is a guideline of the IRS’s position. It is only binding on the recipient of that ruling. Also, as with any advanced planning technique, there are many factors to consider. However, based on PLR 200604028, you can throw away the “crystal ball” and stop trying to plan based on who may die first.

**THIS ARTICLE MAY NOT BE USED FOR PENALTY PROTECTION.**