Chapman and Cutler LLP

Chapman Client Alert

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Estate Planning Options for Married Couples

If you have created an estate plan but have not revisited that plan in the last five years, it is time to do so. In addition to changes in life, changes in the estate tax rules over the last decade have altered the planning options available for many married couples. If the federal estate tax laws are actually repealed by the current Congress, these options will be relevant for all married couples. The purpose of this client alert is to highlight the typical options for how spouse's plan for each other in light of the current and potentially changing estate tax rules.

Shelter Trust Planning

When the federal estate tax exemption was significantly lower, many married couples needed to create a trust, when planning for each other, if they wished to avoid or at least minimize federal and state estate taxes. We will refer to this type of trust as a "Shelter Trust." With the changes in tax rules, most married couples whose net worth is less than $11,000,000 do not need a Shelter Trust to avoid or minimize federal estate tax. However, a Shelter Trust may still be the best option since a well drafted Shelter Trust can provide many non-tax advantages, as discussed below. Additionally, depending on a couple's residency, a Shelter Trust may still be needed to reduce or minimize *state* estate taxes. For example, a couple residing in Illinois, whose combined net worth is close to or more than $4,000,000, should still have Shelter Trust planning in order to reduce or eliminate the Illinois estate tax.

Impact of Having A Shelter Trust

To be effective, a Shelter Trust for a spouse must have some restrictions and has to be administered properly.

Restrictions. There is flexibility in setting up the terms of the Shelter Trust. However, the Shelter Trust has to be restricted enough so that the surviving spouse is not consider the "owner" of the trust assets for estate tax and property law purposes. Terms of the Shelter Trust for a surviving spouse can include:

- Being the trustee (i.e., spouse can be the decision-maker for the Shelter Trust).
- Receipt of the income (interest, dividends, rents, etc.) of the Shelter Trust.
- Receipt of the principal or corpus of the Shelter Trust for defined purposes, like health, maintenance and support.
- Power to direct the distribution of the Shelter Trust to a defined group of others (such as descendants and/or charity).

Administration. During the surviving spouse's lifetime, all assets of the Shelter Trust have to be segregated and maintained in the name of the Shelter Trust and the Shelter Trust must file its own income tax returns. Depending on the terms of the Shelter Trust, the amount of distributions to the surviving spouse, and the surviving spouse's income tax bracket, the income tax paid by the Shelter Trust could be at a higher rate than the surviving spouse's income tax rate.

Tax and Non-Tax Benefits of Shelter Trust. A properly prepared and administered Shelter Trust uses one spouse's estate tax exemption to shelter the trust assets from future estate taxes. A properly prepared and administered Shelter Trust has a number of non-tax benefits as well.

- Estate tax benefits:
  - Assets in Shelter Trust will not be subject to state estate taxes when surviving spouse dies (although exceptions may apply depending on estate tax elections made for the Shelter Trust).
  - Assets covered by the deceased spouse's federal and/or state estate tax exemption, which remain in the Shelter Trust, can grow and appreciate during the surviving spouse's life without being subject to estate tax at the surviving spouse's death.
- Non-tax benefits:
  - Trust assets are generally protected from claims by surviving spouse's creditors.
  - Trust assets could be sheltered from Medicaid/state-qualified medical programs that are

needs-based (trust terms may need to be specifically set up for exclusion from these programs).

- Trust assets are better protected if surviving spouse re-marries.

- Any assets not needed by surviving spouse must ultimately go to individuals or charities as directed by the first spouse to die, subject to any power given to the surviving spouse to re-direct distributions of the Shelter Trust among a defined group of beneficiaries.

Options for Married Couples

Married couples have three typical options for how they leave property to each other: (1) outright, (2) a "disclaimer" Shelter Trust, or (3) a full Shelter Trust. Below is a summary of the pros and cons of each of these options.

Outright – with this option, no Shelter Trust is created. All property will pass directly to the surviving spouse (either by beneficiary designation, joint ownership or by naming the surviving spouse as beneficiary of a trust with full or unrestricted rights and powers).

Pros

- Easy structure. There is no Shelter Trust to maintain and administer.
- Subject to a few exceptions, all assets receive an adjustment to income tax cost basis when the surviving spouse dies.
- Surviving spouse has an unrestricted right to all assets (although this feature may be a Con).

Cons

- There is no way to create a Shelter Trust should estate taxes become applicable, either due to changes in the spouses' circumstances or changes in the estate tax laws.
- Even if there is no federal estate tax, there may be state estate taxes at the death of the surviving spouse (depending on where the surviving spouse lives).
- At the death of the first spouse, his or her unused federal estate tax exemption carries over to the surviving spouse, *but* the amount is fixed (e.g., if it is $5,490,000 at death, that amount stays the same and does not adjust for inflation). In contrast, assets that are placed in a Shelter Trust, up to the exemption amount, and remain in the Shelter Trust are not subject to estate tax at either spouse's death, even if the assets grow well beyond the initial exemption amount.
- There is no way to take advantage of the non-tax benefits of a Shelter Trust.

Who is this type of planning appropriate for? Couples with a net worth that is well below the federal or state estate tax exemption amount, who are unlikely to grow that net worth and who do not care about the non-tax benefits of a Shelter Trust.

Disclaimer Shelter Trust – with this option, all property will pass directly to the surviving spouse as with the outright option but, if the surviving spouse disclaims (a legal refusal to accept) some portion or all of the assets, the estate plan is set up so that the disclaimed property goes into a Shelter Trust.

Pros

- Provides flexibility for the surviving spouse to decide whether there are benefits to creating a Shelter Trust, based on circumstances *at the death of the first spouse*.
    - Spouse can take advantage of the federal or state estate tax benefits of the Shelter Trust.
    - Spouse may be able to minimize the income tax *Cons* of a Shelter Trust by picking and choosing certain kinds of assets for the Shelter Trust.
    - Spouse can decide whether any non-tax benefits of the Shelter Trust are needed (although some of these non-tax benefits may not be available, depending on the state where the surviving spouse lives and when he or she makes the formal disclaimer).

Cons

- Surviving spouse only has nine (9) months from the first spouse's death to make decisions regarding the Shelter Trust.
- Surviving spouse cannot accept benefits from any assets that will be put into the Shelter Trust until the formal disclaimer is made.
- Requires careful titling of assets during lifetime to ensure that the Shelter Trust funding is an option.
- Depending on how asset ownership is set up, having assets that pass into the Shelter Trust may require a probate court proceeding.
- Shelter Trust, if created, may pay higher income tax than surviving spouse.
- Assets in the Shelter Trust, if created, do not receive an adjustment in income tax cost basis at the surviving spouse's death.

- Surviving spouse cannot have a power to direct the distribution of the Shelter Trust to others.
- Surviving spouse can opt for unrestricted rights to all assets (i.e., no Shelter Trust) regardless of any benefits in creating the Shelter Trust.

Who is this type of planning appropriate for? Couples who want flexibility in their estate plan to adopt a Shelter Trust only if needed for estate tax planning, who do not care about the non-tax benefits of a Shelter Trust, and who are less concerned about the surviving spouse having the flexibility to re-direct the distribution of the Shelter Trust to others if a Shelter Trust is created for tax planning.

Full Shelter Trust – with this option, some defined portion or all of the property of the first spouse will pass directly to a Shelter Trust.

Pros

- Spouse can benefit from assets of Shelter Trust immediately.
- Unlike the Disclaimer Shelter Trust option, the surviving spouse can have the right to re-direct distribution of the Shelter Trust to others at the surviving spouse's death (i.e., surviving spouse can re-direct the distribution of the Shelter Trust to children or other family members as circumstances change after the death of the first spouse).
- Spouse receives the full tax benefits and non-tax benefits of a Shelter Trust.

Cons

- Requires careful titling of assets during lifetime to ensure that assets pass to the Shelter Trust.
- Assets in the Shelter Trust do not receive an adjustment in income tax cost basis at the surviving spouse's death.
- Shelter Trust may pay higher income tax than surviving spouse.

Who is this type of planning appropriate for? Couples who will likely be subject to federal or state estate tax or couples who want the non-tax benefits of a Shelter Trust, especially the flexibility for the surviving spouse to re-direct the distribution of the Shelter Trust to a specified group of beneficiaries, such as children and charity. These non-tax factors are often relevant for (a) couples whose children are still fairly young and whose net worth is still growing, (b) couples who have children from a prior marriage, and (c) couples who have very specific desires regarding where the property is distributed when both spouses are deceased.

If you have not reviewed your estate plan in a while or you have not created an estate plan yet, please contact us to discuss the best estate plan for your circumstances and needs.

For More Information

If you would like further information concerning the matters discussed in this article, please contact any of the following attorneys or the Chapman attorney with whom you regularly work:

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