

Have Your Cake and Eat It Too

Use Credit Shelter Trusts With Ascertainable Standards In Marital Planning To Retain Control and Avoid Taxes

Tom and Lynn are married and creating an estate plan. They wish everything to go to Lynn on Tom's death while avoiding, to the extent possible, having the property taxed in Lynn's estate on her death. Their wishes are in conflict with a general principle of tax law: the more control you exercise over property, the more likely you are to be saddled with the associated tax burdens. Through the proper use of a credit shelter trust and powers limited by an ascertainable standard, however, they can ensure that Lynn will be able to maintain some control over the assets without adverse tax consequences.

Using the unified gift and estate tax credit, in 1998 you can shelter \$625,000 of assets from gift and estate tax — \$1.25 million for a married couple like Tom and Lynn. (This exemption equivalent will gradually increase until it reaches \$1 million in 2006 — \$2 million for a married couple.) Furthermore, under the marital deduction, U.S. citizen spouses can pass unlimited amounts to each other free of

gift and estate tax without dipping into the unified credit.

At first glance, these provisions might seem the answer to Tom and Lynn's estate planning needs. On his death, for example, Tom can use the marital deduction to pass all of his estate to Lynn estate-tax free. Without proper planning, however, Tom will lose his unified credit: When Lynn dies and her estate passes to their children, only assets equal to her exemption equivalent will be protected from estate tax.

The Credit Shelter Trust

How can Tom keep his unified credit while still effectively passing all his assets to Lynn? He can provide in his will that on his death a credit shelter trust will be created. The credit shelter trust will be funded with property equal to the exemption equivalent, and Lynn will be the trustee. Lynn can receive the income from the trust for her life and have trust principal available for her support if she

needs it. The trust property will then pass to their children estate-tax free after her death.

Powers Limited By an Ascertainable Standard

But what if Lynn is concerned that the income from the trust will be insufficient to maintain her accustomed standard of living? A common strategy is to grant the surviving spouse a power to invade the trust principal for his or her own benefit. This can, however, lead to unwanted tax consequences.

For example, if Lynn holds a power to distribute property to herself “for any purpose as she deems advisable,” it will be considered a general power of appointment. As a result, the trust property will be included in her estate.

If, however, the power is limited by an ascertainable standard, Lynn will be able to invade principal for her own benefit with no adverse tax consequences. What is an ascertainable standard? In plain English, it is a power that limits the holder’s discretion to distribute principal to measurable, identifiable standards.

For example, if Lynn holds a power to invade principal “to maintain herself in her accus-

tomed standard of living,” the power is limited by an ascertainable standard. As a result, her estate will not include the trust property.

What the IRS and the Courts Look At

The Internal Revenue Service (IRS) generally doesn’t challenge a power to invade principal for the holder’s health, education, welfare or support because tax laws and regulations sanction these powers. To qualify as an ascertainable standard, the power needs to relate to some or all of those factors. In addition, it must be sufficiently determinable to permit the courts to enforce the provision.

In determining whether a power is limited by an ascertainable standard, a court looks at the grantor’s intent, which it can glean from the entire trust agreement, as well as external factors and local law. For example, the power to invade property for the beneficiary’s “comfort” is usually not, by itself, limited by an ascertainable standard. In one case, however, the court held that the power to invade trust assets as determined “reasonably necessary for comfort, support and maintenance” was an ascertainable standard. The court found that the term “comfort” under the particular state law at issue, when viewed in the context of the dead spouse’s intent, was

consistent with the concepts of health, education, welfare and support.

Language found elsewhere in the trust agreement, such as a definitional provision that gives a broad meaning to a particular term, may taint an otherwise ascertainable standard. The fact remains, however, that limiting distributions to those necessary to maintain a beneficiary in his or her accustomed manner of living is not really a limitation at all. There is more leeway than you might think.

Careful Drafting Is Necessary

Powers limited by ascertainable standards offer flexibility, but careful drafting is required. This will ensure that the power passes muster when viewed in light of the actual language fashioning the power, the grantor's intent, and the law of the jurisdiction under which the trust is enforced. We can help you create a limited power that will allow you to have your cake and eat it too. Please call us for assistance.