Abstract: The marital deduction lets assets pass to a surviving spouse estate tax free. But what if one spouse questions how the other will manage the assets after he or she is gone, or wants to protect the survivor's estate from poor management? This article reviews how the qualified terminable interest property trust and the credit shelter trust may answer these estate planning questions.

Place Your Trust In Marital Trusts

QTIP and Credit Shelter Trusts Can Ease Your Estate Planning Concerns

The marital deduction lets all your assets pass to your spouse estate tax free on your death. But what if you question your spouse's ability to manage your assets as you wish, or you want to protect your spouse's estate from poor management and creditors? And what happens on your spouse's death? A pair of relatively simple trusts -- the qualified terminable interest property (QTIP) trust and the credit shelter trust -- may answer your estate planning questions.

The QTIP Trust

Unless you state otherwise in your will or living trust, your assets will pass to your spouse when you die. He or she will then have total control over them. But in some circumstances, you might not want your spouse to have so much control. You may:

- Believe your spouse is incapable of managing money wisely,
- Have children from a previous marriage and want to guarantee they receive a portion of your estate when your spouse dies, or
- Not want your estate to transfer to a new spouse when your remarried spouse dies.

To ensure your spouse doesn't receive total control of your assets, set up a QTIP trust. In most cases, it will freely distribute all trust income to your spouse but restrict his or her access to the principal.

Generally a QTIP trust is a testamentary trust -- you leave instructions in your will or living trust for the QTIP trust to be created and funded at your death. (By contrast, you create a living trust -- also called an inter vivos trust -- during your lifetime, though it may continue after your death.) The trustee should be an individual or institution you trust to manage the assets and make smart decisions about investing and distributing the principal.

You have some flexibility in setting restrictions on your spouse's access to the principal. You can, for example, provide that your spouse may use some of the principal for healthcare, education, maintenance and support. You may want to designate the beneficiary of the trust -- or leave that selection up to your spouse.

The Credit Shelter Trust

A QTIP trust can protect your spouse's estate from poor management and creditors, but it can't shelter the assets from estate tax if they are worth more than the current gift and estate tax exemption equivalent of $675,000 (increasing until it reaches $1 million in 2006). If you face this situation, a credit shelter trust -- also known as a family trust or bypass trust -- may be an option. (See "Save $550,000 in Estate

Tax With a Credit Shelter Trust" for an example of how powerful this trust can be.) Like a QTIP trust, a credit shelter trust is generally testamentary -- created and funded after your death.

The exemption equivalent of $675,000 typically funds the credit shelter trust while the remaining balance of your estate funds the QTIP trust. Assets in a credit shelter trust are not included in your spouse's estate, so they pass estate tax-free to beneficiaries after your spouse's death. But while your spouse is alive, he or she can enjoy the use of the income that those assets earn.
Assets in a credit shelter trust are not necessarily out of your spouse's reach. You can allow for principal distribution to your spouse for certain purposes, such as providing a safety net. Of course, distributions of principal may diminish the estate tax savings later.

Reap the Rewards

When used together, a QTIP trust and a credit shelter trust can be powerful estate planning tools. For more information on how to structure the trusts and how to title your assets to maximize the trusts' benefits, please give us a call. And to learn more about the unlimited marital deduction, please fax back page 6 for a complimentary copy of our Estate Planning Insights report, "Estate Planning With Marital Trust Assets."

Save $550,000 in Estate Tax With a Credit Shelter Trust

The Smiths have a combined net worth of $4 million. When Mr. Smith dies in 2006, his half of the estate passes tax free to Mrs. Smith. She dies later the same year. Because her estate assets are not sheltered, Mrs. Smith's taxable estate is valued at $3 million ($4 million in assets minus the $1 million exclusion). The IRS taxes the estate at a marginal rate of 55%, thus leaving $2.35 million for their children.

The Does also have a net worth of $4 million, but they each provide in their living trusts for a credit shelter trust. When Mrs. Doe dies in 2006, her half of the estate is divided into two equal portions of $1 million each: One portion is placed in the trust and the other portion passes tax free to Mr. Doe. When he dies later the same year, his estate is worth $3 million, $2 million of which the IRS taxes at a marginal rate of 55%. Combining the balance of the estate with the assets in the credit shelter trust, the children inherit $2.9 million.

The Doe's children inherit $550,000 more than the Smith's children do because the Does took advantage of a credit shelter trust.