Supercharged Credit Shelter Trust[SM]

©2006 by Mitchell M. Gans, Jonathan G. Blattmachr & Diana S. C. Zeydel.[1]
All Rights Reserved

Introduction

Many married individuals adopt an estate plan designed to avoid estate tax upon the death of the first spouse to die while taking maximum advantage of the so-called "unified credit" (also known as the applicable exclusion amount). The plan typically involves setting apart the amount sheltered by the unified credit (the "credit shelter" amount) separately, and providing that only the portion of the estate in excess of the credit shelter amount will pass in a manner that qualifies for the marital deduction. Frequently, the credit shelter amount is set apart in trust so that the surviving spouse may benefit from the property if needed without causing those assets to be included in the surviving spouse's estate for estate tax purposes. A credit shelter trust not only preserves the unified credit of the first spouse to die, but also provides an opportunity to leverage the unified credit of the first spouse to die during the lifetime of the surviving spouse: To the extent there is appreciation and/or accumulated income in the trust, it passes upon the surviving spouse's death free of estate tax (and free of generation-skipping transfer tax, assuming an allocation of GST exemption to the trust). The amount in the trust passing tax-free at the surviving spouse's death is enhanced, of course, if trust distributions to the surviving spouse are minimized. The amount in the trust would be further enhanced if the credit shelter trust were the surviving spouse's grantor trust: The surviving spouse's payment of tax on the trust's income would permit the trust estate to grow income tax free. The trust, in other words, would be supercharged. This article will suggest that a lifetime QTIP trust should be used in order to supercharge the credit shelter trust. Given the advantage offered by the Supercharged Credit Shelter Trust[sm], practitioners may wish to consider adopting this drafting approach in many cases.

Background

The unified credit is typically conceptualized as a Federal estate tax exemption or exemption equivalent. The exemption has increased from $60,000 (when it was a true exemption) for many years before 1977 to the current amount of $2 million (and it increases in 2009 to $3.5 million). Under current law, there is no Federal estate tax in

---

[1] Mitchell M. Gans is a professor at Hofstra University Law School in Hempstead, New York. Jonathan G. Blattmachr is a partner in New York, New York, at Milbank, Tweed, Hadley & McCloy, LLP. Diana S. C. Zeydel is a shareholder in Miami, Florida, of Greenberg Traurig, PA. Mr. Blattmachr is co-developer of Wealth Transfer Planning, a computerized software system for lawyers offering specific client advice and document assembly, which is published by Interactive Legal Systems, LLC (ILS). The sample language contained in this article is derived from Wealth Transfer Planning and is published here with the permission of ILS. "Supercharged Credit Shelter Trustsm" is a servicemark of Prof. Gans, Mr. Blattmachr and Ms. Zeydel who hereby grant permission for anyone to use it without charge provided appropriate attribution is given to them for its use.

2010 (so one could view the exemption as unlimited for that year). After 2010, the exemption would revert to $1 million. See section 2010 of the Internal Revenue Code of 1986 as amended ("Code" or "IRC").

In a conventional plan, the first spouse to die does not bequeath all of his or her assets to the surviving spouse via a bequest or other disposition that qualifies for the marital deduction. Were such an approach used, the first spouse's exemption would be wasted. Rather, the exemption amount is typically bequeathed in trust, with the surviving spouse as a beneficiary. As long as the surviving spouse is not given a general power of appointment, its assets will be excluded from the surviving spouse's gross estate for Federal estate tax purposes.

Credit Shelter Trusts

Typically, the plan fully to use the exemption of the first spouse to die is implemented through a "formula" bequest, under which an amount equal to the spouse's unused Federal estate tax exemption is placed in a trust for the benefit of the surviving spouse and descendants. The trust shelters the assets used to fund the exemption from inclusion in the surviving spouse's gross estate for Federal estate tax purposes: Neither section 2036 nor 2038 of the Code can apply because the surviving spouse makes no transfer to the trust; and, if properly drafted, the surviving spouse does not have a general power of appointment over trust assets. Because the trust shelters the amount based upon the unified credit (i.e., the unused exemption) from estate tax in this fashion, it is commonly referred to as a "credit shelter trust."

Structure and Benefits of the Credit Shelter Trust

Some clients may insist on mandating distributions of trust income to the surviving spouse from the credit shelter trust. Although that may provide a sense of psychological and economic security, it is inefficient from a tax viewpoint. Amounts distributed to the surviving spouse, to the extent not expended, will have the effect of increasing his or her gross estate, whereas amounts accumulated in the trust will pass, as indicated, free of estate tax at the surviving spouse's death. In addition, distributions to the surviving spouse will have the effect of depleting a tax exempt trust when it might be possible to provide for the spouse out of what would be estate taxable assets. Moreover, during the surviving spouse's lifetime, income could be distributed to descendants without incurring gift tax. For example, if the trust mandated income distributions to the surviving spouse and he or she then gifted the income received to a child, a taxable gift would occur (to the extent not protected by the annual exclusion under section 2503 of the Code). But, if authorized in the instrument, the income could be distributed by a disinterested trustee directly to the child without generating a taxable gift. (An interested trustee, that is one who is a beneficiary of the trust, could also make the distribution without generating a taxable gift if the trust instrument permits distributions to be made in accordance with an ascertainable standard, such as health, maintenance, support and education.) In addition, the income distribution to the child might produce an income tax savings: the distribution should be taxable for income tax purposes to the child; and, if

the child is in a lower income-tax bracket than the surviving spouse, the difference in bracket will result in a savings. Even if the income is accumulated in the trust, a savings may be achieved: Whereas a distribution to the spouse could generate state or local income tax, it is possible that the trust might not be subject to such a tax.

Where the surviving spouse has sufficient resources, he or she should not receive distributions from the trust. In other words, in order to achieve an optimal tax outcome for the entire family, the surviving spouse should expend his or her own assets (or those in the marital deduction trust) rather than receive distributions from the credit shelter trust. To illustrate, assume that the surviving spouse has access to the following categories of assets: assets held outright by the surviving spouse; assets held in the credit shelter trust; and assets held in one or more marital deduction trusts. Because only the assets held in the credit shelter trust will pass estate-tax free at the surviving spouse's death, it would be preferable to use principal in the marital deduction trust (as it is generally the case that the marital deduction trust will mandate income distributions), rather than principal or income in the credit shelter trust, to enable the surviving spouse to maintain an appropriate standard of living. Under this approach, the assets in the marital deduction trust (estate taxable when the surviving spouse dies) "vanish" while the assets in the credit shelter trust (not estate taxable when the surviving spouse dies) grow. This can be accomplished if the trustee is authorized to distribute principal from the marital deduction trust(s) to the surviving spouse and to accumulate income in the credit shelter trust (in addition, as suggested, it may be helpful from a planning perspective if the trustee of the credit shelter trust were authorized to make distributions to descendants). Where it is anticipated that the credit shelter and marital deduction trusts will be so administered, it may be appropriate to provide detailed authorization to the trustees and, indeed, to encourage them to use this approach. A sample provision might read as follows:

Estate Tax Efficient Shares

I have provided in this instrument, if my spouse survives me, for my estate to be divided into what I perceive to be estate tax efficient shares for those who may succeed to property disposed of hereunder upon the death of my spouse. I understand that the relative size of those shares is dependent upon the tax law in effect at the time of my death and upon elections or other decisions made by my executors/personal representatives. I acknowledge that the interest of my spouse in the shares created hereunder may not be the same and that, if there is no death tax in effect at the time of my death, no estate tax marital deduction share may be created for my spouse. Because benefiting my spouse is one of my primary concerns, I request, but do not direct, that the Trustees of any trust hereunder in which my spouse has an interest benefit my spouse therefrom in a manner that will eliminate or minimize the economic effect upon my spouse of the division of property into separate shares; provided, however, that only a Trustee other than any Trustee who is or in the future may become a beneficiary of a trust hereunder who is referred to herein as a "Interested Trustee" shall participate in any such decision. Without limiting the discretion granted to the Trustees hereunder, without granting my spouse any right to compel the Trustees to do so, and without

imposing any obligation for the Trustees to do so, and solely by way of illustration and not limitation, I authorize the Trustees (other than any Interested Trustee) to pay principal to my spouse from any trust that qualifies for the Federal and/or state estate tax marital deduction while accumulating income in any other trust in which my spouse may have an interest in a manner that the Trustees (other than any Interested Trustee) determine may provide my spouse with approximately the same net benefit (taking into account income taxes and any other factors the Trustees (other than any Interested Trustee) deem appropriate) my spouse would have received had all income or a reasonable unitrust amount, as determined by the Trustees (other than any Interested Trustee), from all trusts in which my spouse has an interest hereunder been paid to my spouse.

Supercharging the Credit Shelter Trust

As suggested, in a conventional plan, the credit shelter trust is created by bequest. Under Subchapter J of the income tax provisions of the Code, unless the trust is a grantor trust under Subpart E of Part 1 of Subchapter J, the income taxation of trust's income is based on the concept of distributable net income (DNI). Under those DNI rules, the trust's income is taxable to the beneficiaries or the trust depending on the amount of distributions made each year. See sections 651-662. Thus, if income distributions to the surviving spouse are mandated or made in the discretion of the trustee, they will be taxed under the DNI rules to the spouse, as a general rule. If, on the other hand, the trust's income is either accumulated or distributed to descendants, it will, of course, not be taxed to the spouse. Suppose, however, the DNI rules could be displaced with the grantor trust rules so that the trust's income, therefore, would be made taxable to the spouse even if no distributions are made to the spouse. (Under the grantor trust rules, the income, deductions and credits against tax of the trust are attributed directly to the grantor as though the trust does not exist and the trust assets were owned directly by the grantor.) If this could be accomplished, the trust would grow income tax free and thus, in effect, would be enhanced by the spouse's income-tax payments. And, assuming an allocation of GST (generation-skipping tax) exemption were made to the trust, the enhancement attributable to the spouse's payment of the income tax could inure to the benefit of lower-generation beneficiaries on a completely transfer-tax-free basis. The credit shelter trust would thus become "supercharged."

How might one structure a credit shelter trust in order to supercharge it? At bottom, the concept rests on Rev. Rul. 2004-64, 2004-2 C.B. 7. In the ruling, the IRS considered the gift tax implications of a grantor trust. In the case of a Grantor Trust, the DNI rules do not apply. Instead, the trust is ignored for income tax purposes and its income is taxed to the grantor. See Rev. Rul. 85-13, 1985-1 C.B. 184. In Rev. Rul. 2004-64, the IRS concluded that the grantor's payment of the tax on the income of a grantor trust does not constitute a taxable gift. For a discussion of the ruling, see M. Gans, S. Heilborn & J. Blattmachr, "Some Good News About Grantor Trusts: Rev. Rul. 2004-64," Estate Planning, Vol. 31 No. 10, at 467 (October 2004). Thus, if a credit shelter trust could be structured so that it was the surviving spouse's grantor trust for

income tax purposes while still functioning as a credit shelter trust for transfer-tax purposes (no inclusion in the surviving spouse's estate), it would be supercharged.

The difficulty, however, is that, under conventional planning, the surviving spouse is not the grantor of the credit shelter trust. The trust is created by bequest under the will (or revocable trust) of the first spouse to die and, therefore, cannot be viewed as the surviving spouse's grantor trust. Nonetheless, under section 678, the trust could qualify as the surviving spouse's grantor trust if he or she were given the right to withdraw the trust principal. While this would be effective in terms of making the trust's income taxable to the spouse, it would be ineffective in terms of the estate tax: Such a withdrawal power is a general power of appointment that would cause the trust's assets to be included in the surviving spouse's gross estate under section 2041 (and a release or lapse of the power during the surviving spouse's life would trigger a taxable gift under section 2514 to the extent not saved by the "five-and-five" exception in section 2514(e)). The critical question, therefore, is how to make the credit shelter trust the surviving spouse's grantor trust without relying on section 678.

Lifetime QTIP Trust for the Spouse Dying First

This can be achieved through the use of a lifetime QTIP trust. To illustrate, assume the wife creates a lifetime QTIP trust for her husband with sufficient assets to use his entire estate tax exemption when he dies. She elects QTIP treatment for the trust on her United States Gift (and Generation-Skipping Transfer) Tax Return (Form 709). (Note that it will not qualify for the marital deduction if the spouse for whom the QTIP is created is not a U.S. citizen. See IRC § 2523(i).) Thus, no gift tax is payable when the trust is created, and the entire trust will be included in the gross estate of the husband when he dies under section 2044 of the Code. While both spouses are alive, the trust is the wife's grantor trust (assuming her husband is a beneficiary with respect to both trust income and principal, the trust is deemed wholly owned by the wife). See IRC §§ 676, 677. Therefore, all of the trust's income (whether allocated to accounting income or to principal) would be taxed to the wife without regard to the DNI rules.

Upon the husband's death, as indicated, the assets in the lifetime QTIP trust created by the wife for the husband are included in his gross estate under section 2044. But estate tax will be avoided to the extent of his remaining Federal estate tax exemption (and as to the entire trust if any assets in excess of the husband's remaining exemption pass in a form that qualifies for the marital deduction for estate tax purposes in his estate). And, assuming the trust is properly drafted, its assets (to the extent of the husband's estate tax exemption) should not be included in the wife's gross estate at her later death. Even though she may be a permissible (or even mandatory) beneficiary of the credit shelter trust created from the lifetime QTIP trust, it will not be included in her gross estate as long as she does not have a general power of appointment and as long as the husband's executor does not make a QTIP election. While, under section 2036, trust assets may ordinarily be included in the grantor's gross estate where the grantor is a beneficiary, the QTIP regulations explicitly preclude the IRS from invoking section 2036 or section 2038 in the surviving spouse's estate in the case of such a lifetime QTIP. See

Reg. § 25.2523(f)-1(f), Example 11. Thus, even if the credit shelter trust is drafted to permit distributions to the wife, it will not be included in her gross estate. In effect, the trust functions exactly as would a credit shelter trust formed from assets in the husband's own estate: A trust using his exemption would be excluded from the wife's gross estate at her later death.

Nonetheless, for income tax purposes, the trust can continue to be treated as the wife's grantor trust after the husband's death, provided the trustee has discretion to make distributions of income and principal to the wife. Regardless of the way in which the trustee in fact exercises this discretion, the trust's taxable income will continue to be attributed to the wife under the grantor trust rules by reason of the wife's discretionary interest in trust income and principal. See sections 676, 677. Most critically, the wife is viewed as remaining the grantor of the trust for income tax purposes – thus triggering section 676 and/or 677 -- even though, at her husband's death, it was included in his gross estate under section 2044. See Reg. §1.671-2(e)(5) (no change in identity of the grantor unless someone exercises a general power of appointment over the trust). As a result, the wife's payment of the tax on the trust's income does not constitute a taxable gift. See Rev. Rul. 2004-64, supra. Thus, even assuming the trustee accumulates the income or distributes it to the descendants, the wife is required to pay the income tax and is not treated as making a taxable gift when she does so. In short, the credit shelter trust is supercharged.

If GST exemption is allocated to the lifetime QTIP trust as is permitted in Treas. Reg. §26.2632-1(c)(2)(ii)(C) and as explained in J. Blattmachr, "Selected Planning and Drafting Aspects of Generation-Skipping Transfer Taxation," The Chase Review (Spring 1996), the transfer tax savings will be further enhanced (although Rev. Rul. 2004-64 does not make explicit reference to the GST, its conclusion that no taxable gift occurs by reason of the grantor's payment of the income tax should likewise apply for GST purposes, see Reg.§26.2652-1).

It is appropriate parenthetically to discuss the allocation of GST exemption in a bit more detail here. As explained in The Chase Review article cited above, the spouse who creates the lifetime QTIP trust may make the so-called "reverse QTIP" election under section 2652(a)(3) when the lifetime QTIP trust is created. In other words, the GST exemption of the first spouse to die will not be allocated to the credit shelter trust formed from that lifetime QTIP trust. Rather, the GST exemption of the spouse who created it will be allocated and allocated earlier in time than will estate tax exemption of the spouse dying first. An example may help illustrate this concept. It is quite certain the husband will die before the wife will. She creates a $2 million lifetime QTIP trust for him. Although she makes the QTIP election to make the trust qualify for the gift tax marital deduction under section 2523(f) of the Code, she "reverses" that election under section 2652(a)(3) for GST tax purposes. Hence, her GST exemption begins to "work" as soon as she creates the trust. Assume that when the husband dies, the lifetime QTIP trust is worth $3 million. The first $2 million goes into a credit shelter trust for the surviving spouse and is GST exempt by reason of *her* allocation of *her* GST exemption to the trust. The extra $1 million in the lifetime QTIP trust the wife created for the husband

goes into a QTIP trust for her which the husband's executor will elect to qualify for the estate tax marital deduction under section 2056(b)(7). And it too will be GST exempt, again by reason of the wife's allocation of GST exemption to the lifetime QTIP trust when she created it. The husband's GST exemption will be allocated to other assets in his estate—these other assets presumably will pass into a so-called "reverse" QTIP trust for the wife. Hence, this strategy not only supercharges the estate tax exemption of the spouse who dies first but, as explained in The Chase Review article, "extra" supercharges the GST exemption of the surviving spouse. Of course, as with all lifetime uses of tax exemptions, there is a risk that exemption is wasted if the assets decline in value. If, in the foregoing example, the assets decline to $1,5 million, the husband's estate tax exemption will remain intact, but a portion of the wife's GST exemption may be wasted.

Finally, the supercharged credit shelter trust also offers an income tax advantage. As with any grantor trust, basis may be "stepped up" under section 1014 at the grantor's death even if the trust is not included in the grantor's gross estate provided the grantor purchases the trust's assets for cash immediately before death (or instead gives the trustee high-basis assets in exchange for the trust's low-basis assets). See J. Blattmachr, M. Gans and H. Jacobson, Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death, 97 J. Tax'n 149 (2002). Thus, whereas in the case of a conventional credit shelter trust there is no basis adjustment at the death of the surviving spouse, the supercharged credit shelter trust does offer the opportunity for such an adjustment.

Creditors' Rights Doctrine

Under the law of most, but not all, states, a grantor's creditors may attach assets in a trust the grantor has created and from which he or she is entitled or eligible in the discretion of a trustee to receive distributions. See, e.g., New York Estates, Powers & Trusts Law 7-3.1; Restatement (3d) Trusts, sections 57-60. The question becomes whether estate tax inclusion in the estate of the spouse who created the QTIP that becomes a credit shelter trust for that spouse might result if, under state law, her creditors could reach the trust's assets.

Because the wife in the above example is the grantor of the lifetime QTIP trust and will also be a permissible beneficiary of the resulting credit shelter trust, it is at least arguable that, under state law, her creditors could attach the trust's assets. Ordinarily, the ability of a grantor's creditors to reach trust assets triggers inclusion in the gross estate under section 2036. See, e.g., Outwin v. Commissioner, 76 T.C. 153 (1981), acq., 1981-2 C.B. 1; Palozzi v. Commissioner, 23 T.C. 182 (1954), acq. 1962-1 C.B, 4; Estate of Paxton v. Commissioner, 86 T.C. 785 (1986); Rev. Rul. 77-378, 1977-2 C.B. 348. As indicated, however, the QTIP regulations explicitly preclude the IRS from invoking section 2036 and 2038 in this context. See Reg. § 25.2523(f)-1(f), example 11 (foreclosing the application of sections 2036 and 2038 in the surviving spouse's gross estate with respect to a QTIP trust previously included in the other spouse's gross estate under section 2044).

Is it nonetheless possible that the IRS could successfully argue that, because of the right of the wife's creditors to reach the trust's assets, she has a general power of appointment triggering inclusion in her estate under section 2041? While the QTIP regulations render sections 2036 and 2038 inapplicable in the wife's estate, they do not rule out the possible application of section 2041. (See, also, Reg. § 20.2041-1(b)(2).) Thus, if under applicable state law, the wife's creditors could reach the trust's assets, the possible resulting application of section 2041 in her estate would make this strategy unworkable because it would cause the credit shelter trust to be included in her gross estate. It is critical, in other words, that the plan be structured so that section 2041 cannot apply in the wife's estate with respect to the credit shelter trust for her benefit formed out of the lifetime QTIP trust she created for her husband.

This can be accomplished in one of two ways. First, section 2041 can be negated through the use of an ascertainable standard relating to health, education, maintenance or support. For example, if distributions from the credit shelter trust to the wife were limited by such a standard, section 2041 could not apply in her estate even if her creditors could access the trust's assets under state law. In those states permitting creditors access, the creditors can only reach the amount that the trustee could distribute to the grantor under a maximum exercise of discretion. See, e.g., Vanderbilt Creditor Corp. v. Chase, 100 AD 2d 544, 437 NYS 2d 242 (2d Dept. 1984); comment f to Restatement (3d) Trusts, section 60. Thus, if the trustee may make distributions only to the extent necessary for the grantor's health, education, maintenance and support, the grantor's creditors are similarly limited. They can only reach the trust's assets to the extent the trustee could properly make payments to the grantor for such purposes. And since Section 2041 of the Code excludes from the definition of a general power of appointment a right to property circumscribed by such a standard, including an appropriate standard in the instrument would preclude the IRS from invoking section 2041 even if the trust were located in a state permitting creditors access. (Further limitations might also be incorporated, such as requiring the trustee to consider other resources prior to making distributions.)

Second, the trust could be formed under the laws of a state that does not permit the grantor's creditors to access trust assets. Where the law of such a state controls (Alaska, Delaware, Nevada, Rhode Island, South Dakota, Utah and, to a limited extent, Oklahoma), it will be respected for Federal estate tax purposes. See, e.g., Estate of German v. United States, 7 Ct. Cl. 641 (1985) (no estate tax inclusion in estate of grantor who was eligible to receive income and corpus from the trust because her creditors could not attach the trust property under the law under which the trust was created); see also Rev. Rul. 2004-64.

In sum, when using a Supercharged Credit Shelter Trust[sm], it is critical to (a) include an appropriate standard in the instrument and/or (b) locate the trust in a state where the grantor's creditors cannot reach trust assets. Failure to do so could potentially result in inclusion of the trust in the surviving spouse's estate. If the suggested approach is used, the lifetime QTIP trust becomes a credit shelter trust with respect to the first spouse to die for transfer tax purposes while remaining the surviving spouse's grantor

trust for income tax purposes, thereby permitting the credit shelter trust to appreciate on an income tax free basis. Given the substantial amount of additional wealth that can be transferred tax-free with the supercharged version of the credit shelter trust (see the accompanying illustration), practitioners should give the approach serious consideration in all cases in which the spouses are willing to consider committing assets to a lifetime trust arrangement.

Reciprocal Lifetime QTIP Trusts: Estate Tax

Under the proposal, instead of creating testamentary credit shelter trusts under the wills or revocable trusts of both spouses, each spouse creates a lifetime QTIP for the benefit of the other, with sufficient assets in each trust fully to utilize the beneficiary-spouse's exemption. This, of course, raises the question whether the "reciprocal trust doctrine" will undermine the effectiveness of the strategy.

In United States v. Estate of Grace, 395 U.S. 316 (1969), the Supreme Court applied the doctrine to the following facts. A husband had created a trust under which the wife was entitled to receive the income for life; the wife was given a special power of appointment exercisable in favor of their descendants and the husband. Fifteen days later, the wife created a similar trust containing the same dispositive provisions for the benefit of the husband. Emphasizing the fact that the trusts were identical and created in the same time-frame, the Court held that, at the husband's death, the trust created by the wife should be included in his gross estate under an earlier version of section 2036. While a trust created for the benefit of the decedent by another party is not includible in the decedent's estate under section 2036, the Court nonetheless invoked the section on the theory that, in substance, the husband was the grantor of the trust nominally created by the wife. In other words, the husband, in substance, created the trust under which he was the income beneficiary. And, under section 2036(a)(1) of the Code, a trust is included in the estate of the grantor if the grantor retained the right to the income for life. It is important to note that, had the Court respected the form of the transaction, neither trust would have been subject to estate tax: the trust created by the husband could not be included in his estate because he did not retain the right to its income, and it could not be included in the wife's estate because, although she had the right to income, she was not the grantor (under a parallel analysis, the trusts created by the wife would similarly be excluded from both estates). For a further discussion of Grace and the reciprocal trust doctrine, see G. Slade, "The Evolution of the Reciprocal Trust Doctrine Since Grace and Its Current Application in Estate Planning," 17 Tax Mgmt Est. Gifts &Tr. Jl (1992).

At first blush, it would seem that the reciprocal trust doctrine should apply where husband and wife simultaneously create lifetime QTIP trusts for each other. Indeed, the case for applying section 2036 in this context may not even depend on the applicability of the doctrine. For if the surviving spouse is entitled to receive income from the trust he or she created after the death of the other spouse, the section applies without regard to the doctrine. See Reg. § 20.2036-1 (applying the section where the grantor retains the right to the income after the income interest given to another person terminates). On closer analysis, however, section 2036 cannot apply in the QTIP context, whether based on the

reciprocal trust doctrine or otherwise. As indicated, the QTIP regulations preclude the IRS from invoking section 2036 in the surviving spouse's estate. See Reg. §25.2523(f)-1(f), Example 11. Thus, the doctrine cannot be used for the purpose of including a QTIP trust created by the surviving spouse in his or her estate. Indeed, given the QTIP regulations, the doctrine is entirely irrelevant for transfer tax purposes in the case of simultaneously created QTIP trusts. It would appear, moreover, to be irrelevant in this context for a second, independent reason: Whereas, in Grace, neither trust would have been subject to estate tax had the form been respected, section 2044 requires that each QTIP trust be included in the estate of the beneficiary/spouse. Thus, unlike Grace, there is no need to disregard the form in order to prevent a problematic estate-tax outcome. For an argument that the doctrine cannot apply where the trust will otherwise be included in one of the spouse's estates, see R. Covey, Practical Drafting (October 1993) at 3402.

There is at least one other reason why the reciprocal trust doctrine may not apply. The "uncrossing" of the lifetime QTIP trusts is unimportant in and of itself as far as estate tax inclusion is concerned as one of those trusts will be included in the gross estate of the first spouse to die (under section 2044 if the doctrine does not apply and under section 2036(a)(1) if it does) and the other in the estate of the surviving spouse (also under one of those sections), as discussed above. The real issue is whether the application of the doctrine would cause the credit shelter trust to be included in the gross estate of the surviving spouse. As indicated, the doctrine applies only where there are two trusts (which under the doctrine are "uncrossed"). But there would not be two credit shelter trusts formed from the lifetime QTIP trusts, but only one. And this trust, at least under general tax principles, is a separate trust from the lifetime QTIP trust that precedes it. Because there is only one credit shelter trust, there is nothing for it to be reciprocal to. Moreover, as explained above, the credit shelter trust, in fact, is created by the surviving spouse, raising the possibility of estate tax inclusion under section 2041 on account of the creditors' rights doctrine (which is "blocked" by limiting distributions to that spouse under an ascertainable standard). If the doctrine applies with respect to the lifetime QTIP trusts *and also to* the successor credit shelter trust from the lifetime QTIP trust, then surviving spouse is not treated, for estate tax purposes, as creating the credit shelter trust—rather the credit shelter trust will be treated as created by the spouse dying first—and that, of course, should totally foreclose the possibility of estate tax inclusion (although, as discussed below, it could destroy the "supercharged" aspect of the arrangement if the doctrine were applied for grantor trust purposes as well.)

Reciprocal Lifetime QTIP Trusts: Gift Tax

The gift-tax analysis is, however, different. If the QTIP trusts are not drafted properly, the reciprocal trust doctrine could present a significant gift tax risk. The IRS could apply the doctrine for the purpose of arguing that the QTIP election is invalid. Consider the QTIP created by the husband, which requires that income be paid to the wife for life. If, as a matter of substance, the wife is viewed as the grantor of the trust, the election would presumably be disregarded: Given the requirement that the grantor's spouse be entitled to the income for life, an election should not be available where the income is payable to the grantor. See T. Herbst, "Lifetime Funding of Reverse QTIP

Trusts Enhances GST Planning," 32 Est. Plan. 28 (2005) (raising a question about the applicability of the reciprocal trust doctrine in the context of lifetime QTIP trusts simultaneously created for the purpose of making an early allocation of GST exemption via reverse QTIP elections). And if the election is disregarded, a taxable gift equal to the entire amount contributed to the trust could result. The reason is the potential application of section 2702. That section provides, in general, that when a property owner creates a trust in which he or she has retained the right to income, he or she is deemed to have made a gift of the entire property contributed to the trust because the retention of an income interest may not be subtracted from the value of the property transferred for gift tax purposes. However, section 2702 does not apply if the transfer in trust is an incomplete gift in its entirety for Federal gift tax purposes. Hence, to ensure that section 2702 cannot apply, the QTIP trusts should be drafted to give the beneficiary-spouse a special testamentary power of appointment. That will render both the income interest and the remainder interest incomplete gifts. See Reg. §25.2511-2 (indicating that, where the donor retains an income interest and such a special power, the gift is rendered incomplete). And, most important, no adverse estate tax consequence would ensue: If the reciprocal trust doctrine does not apply, then Example 11 to Treas. Reg. §25.2523(f)-1(f) will foreclose the application of either or both of sections 2036 and 2038; on the other hand, if the QTIP election proves to be invalid on the basis of the reciprocal trust doctrine, the trust actually created by his wife but deemed under the reciprocal trust doctrine as created by the husband for his own benefit would still be included in his estate but under section 2036 and/or 2038 rather than under section 2044 (with the trust for the benefit of the wife similarly included in her estate on the same rationale rather than under section 2044) and it would still use his Federal estate tax exemption when he dies survived by his wife. Thus, any gift-tax risk that the doctrine poses is easily negated by the special power of appointment without a negative estate tax consequence.

Reciprocal Trust Doctrine and the Grantor Trust Rules

While, as suggested, the reciprocal trust doctrine should not create any estate or gift tax threat, the question remains whether it could lead to a problematic denial of grantor trust status. The key to the success of a Supercharged Credit Shelter Trust^{sm} is that the QTIP created by the surviving spouse constitute that spouse's grantor trust. Were this to prove not to be the case by reason of the doctrine, the trust would not be supercharged. The income of the credit shelter trust, in other words, would not be attributed to the surviving spouse under the grantor trust rules. If, for example, the wife survived and the husband were viewed, in substance, as the grantor of the QTIP (and the successor credit shelter trust) she had created, its income would not be attributed to her under the grantor trust rules. As a result, if she were to pay the tax generated by the credit shelter trust's income, the payment would constitute a taxable gift. Before turning to the question whether the doctrine can be applied to deny the surviving spouse the desired grantor trust status, it is important to emphasize the absence of any downside risk: If the surviving spouse cannot treat the trust as his or her grantor trust, the only adverse consequence is that its income will remain subject to the DNI rules, which is of course the way in which conventional credit shelter trusts are taxed. Thus, if the strategy works, the trust is supercharged; and if it does not, it produces the same outcome as a

conventional credit shelter trust. (If the surviving spouse pays the income tax on the trust income because she believes it is a grantor trust with respect to her, but it turns out not to be her grantor trust, Rev. Rul. 2004-64 would not apply to prevent those tax payments from being gifts to the trust. But if the surviving spouse's powers over the trust include a power to veto distributions to others during her lifetime and a testamentary special power of appointment, those powers would render any gift incomplete although her powers would cause the portion of the trust attributable to those gifts made by her tax payments to be added back into her gross estate, which is the same result as if she had not made the payments of income tax.)

More important than the absence of downside risk, it would seem that the reciprocal trust doctrine should not result in a failure in the desired grantor trust status. The doctrine has been applied in the context of the grantor trust rules. See Krause v. Commissioner, 497 F.2d 1109 (6th Cir. 1974), aff'g, 57 T.C. 890 (1972); see also PLR 8813039 (not precedent), applying the reciprocal trust doctrine for grantor trust purposes which caused the trusts created by a husband and by a wife for each other to be treated as self-settled grantor trusts and thus qualified subchapter S shareholders. However, the doctrine should not be problematic with respect to lifetime QTIP trusts for two reasons. First, both QTIP trusts are grantor trusts; the only question is whether the husband should be treated as owning the trust he created or the one created by his wife (with a parallel question concerning the wife). This is to be distinguished from Krause, where, absent the doctrine, the IRS would have been unable to characterize either trust as a grantor trust (in Krause, the IRS sought to tax the trust's income to one of the spouses). Second, regulations issued in 2000 appear to have abandoned the doctrine for grantor trust purposes. Reg. §1.671-2(e)(1) provides: A "person who funds a trust with an amount that is directly reimbursed to such person within a reasonable period of time and who makes no other transfers to the trust that constitute gratuitous transfers is not treated as an owner of any portion of the trust under" the grantor trust rules." Under this regulation, the person who makes the reimbursement is the trust's owner for grantor trust purposes. See Reg. §1.671-2(e)(6), Example 3. Thus, unless the person who creates the trust receives a "direct reimbursement," the creator of the trust is treated as the grantor for grantor trust purposes. In the case of simultaneously created QTIP trusts, no such direct reimbursement occurs. Assuming again that the husband is the surviving spouse, he is treated both before and after his wife's death, under the regulation, as the grantor of the QTIP he had created for her benefit because she did not directly reimburse him. At worst, she might could be viewed as having indirectly reimbursed him (by creating the QTIP for his benefit). As a final observation about the regulation, the seeming decision to abandon the doctrine in this context -- and thereby narrow the number of cases in which a trust is treated as a grantor trust -- is not surprising. After all, at the time this regulation was promulgated, the IRS had already come to fully appreciate the fact that the grantor trust provisions are more helpful than harmful to taxpayers. Lastly, even if the QTIP trusts are deemed reciprocal, it does not necessarily follow that the doctrine applies to the credit shelter trust. Not only is the credit shelter trust a separate and distinct trust created upon the death of the spouse first to die (and only one credit shelter trust is created), but at that point, there is no other grantor trust that it could be reciprocal to because the other grantor has died. Therefore, it seems impossible, even if the QTIP

trusts were treated as reciprocal for grantor trust purposes, to find that the credit shelter trust is reciprocal, and thus not a grantor trust with respect to the surviving spouse who created it.

Why Take Any Risk?

Although it seems reasonably clear that simultaneously created QTIP trusts can be used to create a Supercharged Credit Shelter Trust[sm] and that the reciprocal trust doctrine does not pose any serious threat to this strategy, it is probably prudent to draft the documents so that there is no risk of failure. This can be accomplished in one of two ways. First, if the remainder interests are not identical, the doctrine may be rendered inapplicable. In Levy v. Commissioner, TC Memo 1983-453, a husband and wife created trusts on the same day, giving each other an income interest. One trust gave the beneficiary/spouse a special power of appointment; and the other did not. As a result of this difference in the terms of the trusts, the reciprocal trust doctrine was not applied. In reaching this result, the court referenced the following language in Grace: "The reciprocal trust doctrine does not purport to reach transfers in trust which create different interests and which change the effective position of each party vis a vis the [transferred] property ...," Indeed, perhaps, of even greater importance, the IRS had conceded that, if valid, the special power of appointment in the wife prevented the two trusts from being interrelated and, therefore, subject to the reciprocal trust doctrine. Although the IRS contended that the provision creating the special power of appointment was invalid under state law (New Jersey) or otherwise worthless, the court concluded otherwise. It should be noted that the wife's power of appointment was currently exercisable, which is, of course, not permitted in a QTIP trust. Nevertheless, Levy does endorse the proposition that, where the trusts have different terms, they are not interrelated and are, therefore, not subject to the reciprocal trust doctrine. And although it is arguable that the Tax Court in Levy was wrong in insisting that, under the doctrine, the terms must be identical, see Estate of Green v. U.S., 68 F.3d 151 (6th Cir. 1995) (Jones, J., dissenting), the IRS has embraced Levy. See PLR 200426008 (not precedent). Second, even assuming that the terms of the two trusts are identical, the doctrine should still not apply if they are not created in the same time-frame. See Grace (emphasizing that the trusts were interrelated because of the parallel terms and because created within a fifteen-day period).

Thus, in order to eliminate any risk that the strategy might fail, the trusts should be created at two different points in time (separate by months, not by days as in Grace). In addition, they could be drafted differently. So, for example, as in Levy, one trust might contain a special power of appointment while the other would not (although, as suggested, it may be preferable to include the power in both trusts in order to negate any taxable gift should the IRS argue that the QTIP election is invalid, but the power could be exercisable in favor of different classes of appointees and, perhaps, might be exercisable only with the consent of a non-adverse party). One trust might provide that an invasion could only be made after the spouse's other resources are taken into account, while the other might direct that the existence of such resources is irrelevant. Other differences might relate to the income interest. For example, one lifetime QTIP trust might incorporate a unitrust approach while the other would preclude the trustee from using this

approach. Also, having different trustees under the two instruments may further help block the application of the doctrine as may funding each trust with different assets and with different values. Given Grace, and the Tax Court's application of Grace in Levy, it would seem that either a difference in timing or a difference in terms should suffice to eliminate the threat of the doctrine. Nonetheless, cautious practitioners may choose to vary both the timing and the terms.

Summary and Conclusions

Given the additional wealth the Supercharged Credit Shelter Trust[sm] provides for descendants, as compared to the amount of wealth provided under a conventional credit shelter trust, it probably should be considered in all cases where the spouses have sufficient net worth. Although the reciprocal trust doctrine may be perceived as posing a threat to the viability of the strategy, with proper drafting it does not create any additional estate or gift tax risk, it poses no downside risk for income tax purposes, but most importantly, the application of the doctrine may be effectively avoided by varying the timing and provisions of the two trusts. Thus, the strategy provides a sound means significantly to enhance the effectiveness of the Federal estate tax exemption of the spouse dying first and, through reverse QTIP elections with respect to each lifetime QTIP trust at the time each is created, the GST exemptions of both of spouses .

Chart

Amount in Credit Shelter Trust at Death of Surviving Spouse

Assumptions: $2 million initial funding; 8% annual return; 25% effective income tax on undistributed income

Amount in Trust (in Millions)

Years Between Deaths of Spouses	Payment to Spouse Each Year @ 4%	No Payment to Spouse (Spouse Not Taxed)	No Payment to Spouse (Spouse Pays Income Tax)
5	$2.32	$2.68	$2.94
10	$2.69	$3.58	$4.32
15	$3.12	$4.79	$6.34
20	$3.61	$6.41	$9.32
25	$4.19	$8.58	$13.7