Essential ingredients in estate planning

Certainly, a will is an important first step in making certain that one's assets pass to loved ones in the manner desired. Yet, for people of significant means, although a will may serve as an excellent blueprint, it is unlikely that, on its own, this document will be sufficient to meet a family's needs. Often, certain objectives and family circumstances require more sophisticated strategies.

In many instances a trust used in conjunction with the federal estate tax marital deduction can prevent assets passed on to one's beneficiaries from facing severe tax erosion. And, in special situations—a second marriage or marriage to a spouse who is not a U.S. citizen—marital trust strategies can offer extremely valuable assistance.

But are estate taxes still important? The answer is, clearly, yes. You might think otherwise given the fact that, thanks to legislation in 2001, exemptions from tax are growing over the years, and tax rates are dropping. There's even a year (2010) when the tax will be repealed—although the repeal is only for that year. There have been several attempts to make the repeal permanent, thus far without success. In other words, counting on Washington to eliminate the need for planning is an iffy proposition.

A strategy to reap tax benefits

Suppose Husband and Wife have assets worth a total of $2.5 million. Husband dies, leaving his assets outright to Wife. There's no estate tax to pay at his death because an unlimited marital deduction wipes the slate clean. But later, when Wife dies and leaves the full $2.5 million to their children, only one estate tax exemption (Wife's) is available to protect the family's assets. Husband's exemption has been lost, and a significant estate tax may have to be paid.

The amount of tax depends upon what year Wife dies. If she dies in 2009, for example, there would be no additional estate tax, because the exempt amount that year is $3.5 million (assuming, of course, the scheduled increases in exemptions remain in place in the coming years). In 2010 there will be no tax on estates of any size, so no tax would be due. But in 2011 and after, only $1 million will be protected, leaving $1.5 million exposed to taxes at rates that will begin at 37%.

A better plan: Husband's will could have called for the creation of a "bypass trust." Upon Husband's death the trust would be funded with no more than the amount that the estate tax exemption will shield from tax. Although the trust's assets ultimately must pass to a beneficiary or beneficiaries other than Wife, she can be entitled to all of the trust's income for her life and even be able to use some of the trust's assets for her support. Now, the exemption has bypassed Wife's estate and is sheltered completely from tax. When Wife dies, only the marital deduction trust would be subject to tax, and depending upon the size of her estate, taxes can be reduced substantially, if not eliminated altogether.

A strategy as a result of remarriage

Generally, in order to take advantage of the marital deduction, the property must be transferred to a spouse without any strings attached. For example, if Husband had left his property to Wife on condition that she not remarry, the bequest would not have qualified for the deduction. In tax terms Wife would have a "terminable interest"—a bequest of property that places a condition, unrelated to Husband's death, on her right to receive the property. Terminable interests, generally, make a bequest ineligible for the marital deduction.

For certain families this rule can pose a problem: Say that Husband has children from a prior marriage. He wants to provide support for his current spouse while she lives, but upon her death he wants his assets to pass to his children. Suppose that he divides his property between them, giving Wife a lifetime use of his assets, which then pass to his children upon her death. This scenario creates a terminable interest in what he leaves to his current spouse (only the lifetime use of the assets) and causes his estate to lose the marital deduction.

Congress has created a special exception to the terminable interest rule that allows Husband to preserve his marital deduction. He can set up a "qualified terminable interest property" (QTIP) trust that allows him to leave his assets to Wife while, at the same time, putting on a restriction that only she have lifetime use of the assets and permitting the trust's assets ultimately to pass to his children at her death.

For a QTIP trust to work successfully, Husband's executor must elect to take advantage of the QTIP deduction. It can't happen automatically. Wife must have the right to receive all the income, paid at least annually for her entire lifetime, without any restrictions. In addition, at Wife's death her executor has to include the portion of the trust's assets for which the QTIP election was made in her estate, and tax will have to be paid at that time.

A strategy for a noncitizen spouse

When a bequest is made to a spouse who is not a citizen of the United States, what's to stop that spouse from enjoying the tax benefits of the marital deduction here and then moving back to his or her native land, thereby depriving Uncle Sam of any possibility of levying tax on those assets?

Congress thought about that question and came up with an answer: There's no automatic marital deduction when the surviving spouse is not a U.S. citizen. The only way to ensure that the deduction will be available is to set up what's called a Qualified Domestic Trust (QDT).

Again, there are technicalities that must be followed. At least one trustee of the QDT must be a U.S. citizen or a domestic corporation (such as a bank or trust company). The surviving spouse may use any income received from the trust but cannot withdraw the inherited assets put into the QDT, except under certain conditions. Finally, of course, the executor of the survivor's estate must see to it that the QDT is included in the estate for tax purposes.

Look for guidance

Do you have a current estate plan that makes the most efficient use of the marital deduction? Will a trust provide a solution in your circumstances? Regular review of your plans is important. If you haven't done so recently, we recommend that you contact your attorney, trust officer and other financial advisors for a strategy session soon.

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Any developments occurring after January 15, 2007, are not reflected in this article.