



THE RACK LAW FIRM, P.C.

A PROFESSIONAL LAW CORPORATION

249 Central Park Avenue, Suite 220
Virginia Beach, VA 23462

p 757 . 605 . 5000

f 757 . 605 . 5020

WWW.RACKLAW.COM

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Estate Tax Exemption Trusts

Under the current estate and gift tax laws, individuals who meet their demise in 2008 with taxable estates under \$2,000,000 are not subject to estate taxes at death. This figure represents the “estate tax exemption amount,” and it is slated to increase to \$3,500,000 in 2009. (See Estate Tax Table). For spouses who leave all of their assets to the other, whether by simple wills or simply joint ownership, there is normally no estate tax at the first death. However, at the second death, the estate tax exemption of the first to die is “wasted,” meaning that the survivor is only able to shelter an amount less than current exemption amount.

Good estate planning involves a combination of title changes and estate planning documents that include an estate tax exemption trust. These trusts were once commonly drafted into wills and referred to as “Trust B” or “Credit Shelter Trust,” a reference to the pre-2001 tax laws based on a “unified credit” against both estate and gift taxes. They are now most often found in revocable “living” trusts and referred to as “Family Trusts” or “By-Pass Trusts.” The strategy is to fund the Family Trust with assets in an amount up to the estate tax exemption amount, to be administered by a trustee for the benefit of the surviving spouse and/or children. At the surviving spouse’s death, the Family Trust assets are not included in his or her estate, since they were not owned by them outright.

Assets in the estate of the first spouse to die which exceed the estate tax exemption amount as his or her death are typically directed into a marital trust for the surviving spouse so that they qualify for the marital deduction (estate tax deferred until second death, taxed in survivor’s estate). (See QTIP Marital Trust).

The survivor is normally able to receive dividends and interest income from the Family Trust (not insignificant if the principal is \$2,000,000), as well as amounts of principal in the discretion of the trustee. If the spouse wishes to serve as trustee, he or she must be limited by the terms of the trust to distributions of principal only for support, health and maintenance, or the Family Trust assets will be included in the survivor’s taxable estate at death, defeating the primary purpose of the trust.

At the survivor’s death, the Family Trust assets may be distributed outright and the trust terminated, or they may be held in further trust for the ongoing benefit of the family. This structure should address the varying circumstances of the heirs: i.e., immaturity or under a set age, such as 35 or 40; under a physical or mental disability; under the watchful eyes of creditors; or, under a clouded marital situation. With careful drafting and the optimum choice of successor trustees, the estate exemption trust has the potential to avoid significant, unnecessary estate taxation and protect the family wealth for generations.

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