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Living trusts as a means to save estate taxes and avoid probate

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This article is meant to familiarize practitioners with the use of living trusts as a means to save estate taxes and avoid probate. The estate tax savings detailed in this article are available with a will, but the avoidance of probate requires fully funded living trusts, unless the person has less than \$50,000 in assets. In Illinois, estates of \$50,000 or less can be distributed by the use of a small estate affidavit. 755 ILCS 5/25-1. Many of the nuances of this area of law, especially when dealing with particularly large estates, are well beyond the scope of this article.

Estate and gift tax can be a complex area of law. This article will simply try to convey a basic living trust estate plan for a husband and wife through the use of the Internal Revenue Code ("IRC") unlimited marital deduction, IRC § 2056, and the unified credit against estate and gift tax (unified credit), IRC § 2010. This common Mom and Pop estate plan can save hundreds of thousands of dollars in estate taxes and avoid probate upon disability and death.

Mom and Dad America may come into your office and tell you that they have heard great things about living trusts. They will want to know what living trusts can do for them. The answer is that a properly drafted and fully funded living trust can for many save hundreds of thousands of dollars in estate taxes and allow them to avoid probate court costs, fees, time delays, and inconveniences upon disability and death.

In 1999 the IRC unified credit against estate and gift tax is \$215,300. What that means is that every person who dies in 1999 can leave upon death (or have given away during life) assets with a total value of up to \$650,000 estate/gift tax free. That is because the estate/gift tax on \$650,000 is \$215,300. The \$650,000 is called the "applicable exclusion amount." IRC § 2010(c). The unified credit (and thereby the applicable exclusion amount) will increase incremental-

ly over the next seven years until 2006 when the exclusion amount will reach \$1,000,000. In the absence of further congressional action there will be cost of living adjustments to the \$1,000,000 in 2007 and thereafter.

The basic living trust estate plan is accomplished by creating separate living trusts for Mom and Dad. (It is possible to do this with a single trust, although a single trust may invite scrutiny from the IRS much more than if two separate trusts are used.) Ownership of Mom and Dad's assets are transferred to the trusts and their trusts are made the beneficiaries of certain accounts. Mom and Dad will be the trustmakers, trustees, and beneficiaries of the trusts during their lives, and, therefore, they are not giving up any control over these assets. Also, they can modify or revoke each of their trusts during their lives, so their plans can be modified if their personal situations change.

The avoidance of living (disability) or death probate is the easy part. Trust property is managed by a trustee according to the directions in the trust. While alive, the trustmaker is the acting trustee. Mom and Dad usually name each other as co-trustees and first successor trustees of each other's trust. When Mom or Dad is no longer able to manage her or his affairs because of disability or death, the successor trustee immediately takes charge without having to go into court. Successor trustees, after the surviving spouse, are trusted persons such as children or bank trust departments. The clients name their successor trustees.

While Mom and Dad are alive, the trust assets will be used for their benefit whether or not they are acting as trustees. When Mom and Dad have both died, the assets will be distributed to their intended beneficiaries just like with a will. But, unlike with a will, the courts do not have to get involved. No probate attorney fees or court costs will be incurred.

Besides the cost savings of avoiding probate, the time saved through the use of living trusts is a huge benefit. Upon death or disability of a trustmaker the assets of a living trust immediately transfer to the successor trustee to be administered according to the trustmaker's instructions in the trust. When a will is probated the assets of the estate are tied up for a minimum of six months while the claim period runs, and often much longer than that. Furthermore, real estate is subject to probate in the state where it is located. Placement of a real estate in a living trust will avoid such ancillary probate.

The estate tax savings occur when Mom and Dad have both died. This is because the unlimited marital deduction,

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IRC § 2056, provides that a husband and wife who are U.S. citizens can leave an unlimited amount of assets to each other without paying any estate taxes. This sounds great, but the IRS catches up with Mom and Dad on the death of the survivor. When the survivor of Mom and Dad dies he or she can only pass on an amount equal to the applicable exclusion amount estate tax free. With proper planning, at the death of the survivor of Mom and Dad, they will be able to pass on two times the applicable exclusion amount estate tax free.

The plan requires that upon the death of the first to die of Mom and Dad the decedent's trust splits into two trusts, the "credit shelter trust" and the "marital trust." Let's say Dad dies first. With proper drafting Mom can be the trustee of both Dad's credit shelter trust and marital trust, as well as her own trust. The credit shelter trust is funded with assets of Dad's trust with a total value equal to the applicable exclusion amount for the year of his death. For example, in 1999 the credit shelter trust would be funded with \$650,000 in assets. The marital trust receives the rest. Dad's estate is not taxable because he uses two tools allowed by the Internal Revenue Code: First, the \$650,000 passed to the credit shelter trust utilizes Dad's applicable exclusion amount and thus passes estate tax free; Second, the assets passed to the marital trust utilize the unlimited marital deduction and also pass estate tax free. On the death of the first to die of Mom and Dad there will not be an estate tax to pay.

When Mom dies the IRS is going to deem Dad's marital trust assets as part of Mom's estate. Therefore, the plan can provide that Mom can do anything she wants with Dad's marital trust assets. For convenience, Mom may want to transfer all the assets in Dad's marital trust into her own trust. Mom's use of the marital trust may be restricted as long as she is entitled to receive all of the trust's income. Restrictions on the use of the marital trust are common in situations where there are children from a prior marriage.

However, if the trust is drafted properly, the assets of Dad's credit shelter trust will not be includible in Mom's estate. For this plan to work, Dad's credit shelter trust must provide that the principal can be used by Mom, if at all, only for her health, support, maintenance, or education. IRS § 2041(b)(1)(A). Basically, if Mom needs the assets for her support, she can use them. Also, Mom may receive all the income generated by Dad's credit shelter trust. If Mom does not use up the assets in Dad's credit shelter trust, upon her death the remainder will be distributed to the intended beneficiaries estate tax free. Any growth in the value of Dad's credit shelter trust assets will also pass estate tax free.

The following example will demonstrate the estate tax savings in this common plan. Let's say Dad dies in 2004, when the applicable exclusion amount is \$850,000, and Dad has enough assets in his trust so that a full \$850,000

goes into his credit shelter trust and \$50,000 goes into his marital trust. Now Mom dies in 2006 with \$1,000,000 in assets. This amount includes all the assets in her trust and those remaining from Dad's marital trust. With this plan all of the assets in Dad's credit shelter trust and all of Mom's assets (including Dad's marital trust), a total of \$1,850,000, will pass to Mom and Dad's intended beneficiaries estate tax free. This is because the \$850,000 in Dad's credit shelter trust passed estate tax free using Dad's credit and the remaining \$1,000,000 uses Mom's 2006 credit of \$345,800 (which has an applicable exclusion amount of \$1,000,000).

If Dad had simply left everything to Mom in the above example, on Mom's death the intended beneficiaries would have to pay \$367,500 in estate taxes out of those assets. That is because all of Dad's assets will be includible in Mom's estate for estate tax purposes. Mom still gets her \$345,800 estate tax credit, but it is not enough to cover the \$713,300 in estate taxes on \$1,850,000. Obviously, estate tax rates are very high. For example, at \$650,000 the estate tax rate is 37%; at \$2,000,000 it is 45%; and at \$3,000,000 it reaches the maximum rate of 55%. IRC § 2001(b).

The above estate planning tactic is common and quite basic, though the trusts have to be drafted carefully and the clients should be advised properly so that the plan is followed through. There are several more estate planning devices that are commonly used to reduce clients' exposure to estate taxes. Examples of these are qualified terminable interest property trusts ("QTIPs"), which are common in second marriage situations, generation skipping tax ("GST") planning, and irrevocable life insurance trusts ("ILITs"). With larger estates more involved devices such as charitable lead/remainder trusts ("CRTs"), and family limited partnerships ("FLPs") are often worthy of consideration.

If you would like to discuss estate planning further or are looking for co-counsel or a referral attorney please feel free to call one of the authors at (312) 236-4646.

Spring cleaning—A dozen pointers for purging files

By Scott Mittman

The ABA and others who issue ethical rules tell you that you *don't* have a general duty to keep all files forever and ever. But your good common sense tells you that when it comes time to close clients' files, many legal and ethical issues should govern storing or destroying the information.

Your clients and former clients reasonably expect that you, their lawyer, will not prematurely or carelessly destroy any of the valuable or useful information in your files. So, when closing files, the first thing to do is make immediate contact with each affected client to determine if the client wants the file returned. If so, you may want to copy the file before releasing it. If the client does not want the file, review it and place anything of value at the front to make certain that these items are not accidentally destroyed.

Ideally, you and/or your employer have a closed-file retention or purge policy in place. Such a policy may include the following guidelines for closing files:

1. Before destroying any file, the lawyer or law firm

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