

# *Formula and Disclaimer Bypass Trusts Explained*

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As you may know, unless Congress acts, as of January 1, 2013 the federal estate tax exemption amount is scheduled to drop from \$5.12 million to \$1 million, and the maximum tax rate will increase from 35% to 55%. In addition, New York and Connecticut each levy state estate taxes on estates over \$1 million and \$2 million, respectively.

Formula and disclaimer bypass trusts are irrevocable trusts used by married couples to minimize estate taxes on their combined estates. These credit shelter trusts work by channeling the assets into a trust for beneficiaries, such as the couple's children or other family members. Either type of trust may be a useful component of your estate plan, depending on your needs and goals. As with any planning, there are advantages and disadvantages to consider, as discussed below.

**ISSUE:** If all of one spouse's assets pass to the other on the first spouse's death – a common strategy in basic estate planning – the benefit of the first spouse's estate tax exclusion may be lost upon the death of the second spouse.

**EXAMPLE:** Tom and Dawn are married with two children. Both are U.S. citizens and have not made any lifetime taxable gifts.

Tom passes away leaving \$2 million to Dawn. Tom's estate qualifies for an unlimited marital deduction; no estate taxes are payable. However, if Dawn later dies leaving the same \$2 million in assets to her children (under current law applicable in 2013 and without any tax planning), her estate will owe \$435,000 in federal taxes alone. Now imagine if Dawn dies five or ten years later. As the assets grow in value, so do the amounts payable to the IRS and state tax authorities.

**SOLUTIONS:** **Formula or Disclaimer Bypass Trust;** Portability (possibly); Inter Vivos Gifts; Living Trusts; Advanced Tax Planning Options

**Formula Trusts.** Formula trusts are so named because they operate based on a certain written formula in the will. These trusts are “hardwired” into an estate plan so that an amount equal to the federal exclusion passes into a trust for beneficiaries other than the surviving spouse (such as a couple’s children). Since the tax-free amount of a deceased spouse’s exclusion never becomes an asset of the surviving spouse, the exclusion is preserved. A bypass trust structure often consists of two trusts, commonly called an A/B Trust, in which the federal exclusion amount funds the B Trust and the rest passes to the spouse in an A Trust or directly.

**Disclaimer Trusts.** With a disclaimer trust, a surviving spouse must affirmatively make a timely election to create an A/B or other Trust structure. This allows for greater flexibility in planning – often the name of the game with the ever-changing estate tax landscape – but also has some potential disadvantages as further described below. In addition, if a timely election is not made, the surviving spouse loses the deceased spouse’s estate tax exclusion.

**Portability (not applicable in 2013 unless extended).** Since 2010, one tax-mitigation solution (often substituting for lack of planning) has been “portability” of a deceased spouse’s unused exclusion amount. Portability allows a transfer of the exclusion to the surviving spouse if a timely election is made (in such case, the surviving spouse makes use of the exclusions of both spouses). However, portability is set to expire on December 31, 2012 and is not applicable at the state level in New York or Connecticut. In addition, reliance on portability has other disadvantages that are beyond the scope of this document (e.g., extends the statute of limitations on tax audits of deceased spouse to the date of the surviving spouse’s death and is limited to a single deceased spouse’s exclusion amount if the surviving spouse remarries, ultimately leaving less for the deceased spouse’s heirs).

**Inter Vivos Gifts.** Lifetime gifts are (among other things) a means to move property out of an estate, thereby reducing the assets subject to tax. As with portability, the details of gift tax rules are beyond the scope of our discussion here. It should be noted that any plan to move assets out of an individual’s estate should be carefully considered so that the person has sufficient assets for support during his/her lifetime.

**Other Options.** As you would expect, there are additional tax and non-tax estate planning options available, particularly for individuals with large estates, clients who do not qualify for an unlimited marital deduction (e.g., if one spouse is not a U.S. citizen) and those with specialized planning needs.

## Features of a typical formula bypass (A/B) trust:

- If the trust is created by will, the terms can be amended and the trust is revocable until the death of the first spouse
- Upon the death of the first spouse, the “B Trust” is funded with estate assets up to the exclusion amount (e.g., \$1 million federal exclusion in 2013)
  - o At this point, the B Trust becomes “irrevocable”
  - o Legal and administrative expenses are payable, as with any trust
  - o Surviving spouse may invade the B Trust principal for health, education, maintenance or support (HEMS) under “ascertainable standards”
  - o Annually, surviving spouse may also withdraw up to greater of 5% or \$5000 of the B Trust principal for any reason
  - o Finally, surviving spouse receives all income generated by the B Trust
  - o The surviving spouse can be given a power to appoint all or any of the assets in the B Trust to a limited class of beneficiaries
    - Beneficiaries cannot include the spouse, his/her creditors, his/her estate, or the creditors of his/her estate
    - This is called a "special" or "limited power of appointment"
    - The surviving spouse can appoint the assets in the B Trust to the specified beneficiaries in any proportion that he or she desires
- Assets in B Trust do not get a “step up” in basis upon death of second spouse
- The balance of the assets often fund a revocable marital trust (“A Trust”) or can be left directly to the surviving spouse
  - o Surviving spouse has power to spend without restriction and change terms

<b>First Spouse’s estate:</b>	
<b>A Trust or Directly</b>	<b>B Trust</b>
<i>For surviving spouse</i>	<i>For heirs other than surviving spouse</i>
Balance over exclusion amount	Estate up to federal exclusion
	<i>For surviving spouse</i>
	HEMS + 5% or \$5000 annually
	Income
If A Trust, then	
Revocable	Irrevocable
Survivor’s SS#	Separate tax ID# and reporting

## May Be Suitable for Clients who:

- Have combined assets exceeding twice the federal exclusion amount
- Desire greater control over or certainty in the estate planning process
- Are concerned the surviving spouse may not want to make decisions required for disclaimer trust (see below) and/or be able to manage the assets independently
- Want to protect the assets against creditors
- Are both U.S. citizens

## Features of a typical disclaimer trust:

- Terms similar to above except as noted here
- Surviving spouse must disclaim relevant portion of assets on a timely basis for trust to be funded, otherwise the benefit of the trust structure lost
- Allows greater flexibility than formula trust
- Surviving spouse cannot have special power of appointment over assets and beneficiaries

<b>First Spouse's estate (depending on whether assets disclaimed):</b>	
<b>A Trust or Directly</b> <i>For surviving spouse</i> Balance over exclusion amount	<b>B Trust</b> <i>For heirs other than surviving spouse</i> Estate up to federal exclusion
	<i>For surviving spouse</i> HEMS + 5% or \$5000 annually Income
If A Trust, then Revocable Survivor's SS#	Irrevocable Separate tax ID# and reporting
<u>OR</u>	
Greater portion of assets than above or all assets	Lesser portion of assets or no B Trust formed (cost of administration to be considered)

## May Be Suitable for Clients who:

- Have combined assets exceeding the federal exclusion amount
- Desire control over the estate planning process
- Are comfortable that surviving spouse can
  - make independent decisions, after seeking advice from informed sources, about how much of the estate, if any, should be disclaimed,
  - make a timely disclaimer if warranted, and
  - manage and (be trusted to) pass on an inheritance intended for future heirs
- Want more flexibility than a formula trust in the face of changing tax laws

## **Conclusion**

Estate planning decisions are very personal to the individuals making them and depend on your desires, objectives and even fears in the process. The advantages of preserving assets for your heirs and achieving control over your estate must be weighed against the restrictions, complexities and costs of a trust structure. In addition, your goals and needs may change over time.

Feel free to contact me to discuss either of the above trust structures or other options. Best of luck with your estate planning and other major financial and life decisions.

**This memorandum is current as of November 27, 2012.**

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