

Trusts for Married People

Summary

Advantages of Trusts for Married People

If married couples own more than about \$2 million in assets, they may be able to reduce federal estate taxes by having a living trust drafted. Living trusts can provide for young children or other dependents in case of a family disaster. They can also save heirs money, time, and headaches by avoiding the court probate process.

(For a more general introduction to revocable living trusts, please see our "[Trusts vs. Wills](#)" information sheet.)

Warning for Couples with Older Bypass or A-B Trusts

Married couples with older trusts should seriously consider having them redrafted. Trusts written for couples before the federal tax law changes of 2001 may contain restrictions that are no longer necessary. In particular they may overly limit the surviving spouse's access to assets in the estate after the first spouse passes away. If you have an older trust it may be a bypass trust, also known as an A-B or "B" trust, credit shelter trust, credit shelter exemption trust, exemption trust, credit trust, or nonmarital trust. Bypass trusts drafted before the early years of this decade are now inappropriate for many middle-income people. The trouble is, bypass trusts create an inflexible requirement to divide an estate into separate parts when one spouse passes away. The trust usually divides the household assets at the time of the first spouse's death, to create a "survivor's trust" to hold assets for the surviving spouse, and a "bypass trust" to hold the deceased spouse's part of the assets. The surviving spouse has full and complete access to the survivor's trust and receives income from the bypass trust. However, the bypass trust is usually intended primarily to benefit the beneficiaries of the deceased spouse. That is, typically the surviving spouse receives interest, rent or dividends from the bypass trust property but is essentially a caretaker of the underlying property on behalf of the couple's children or others who will inherit it after the surviving spouse's death. Typically, the surviving spouse has very limited access to the principal of the bypass trust.

The disadvantages of bypass trusts are: 1) The surviving spouse may not have full control over enough money to comfortably sustain his or her standard of living; 2) bypass trusts are no longer necessary as a tax saving device for married couples with less than about \$2 million in assets, and 3) Bypass trusts may cause unnecessary complications and expenses for the spouse who survives

Advantages of Disclaimer Trusts

As an alternative to the bypass trust, the disclaimer trusts we prepare *do not force* the estate to be split when one spouse passes away. In contrast to bypass trusts, disclaimer trusts give the surviving spouse the *option* to split the trust, in whatever proportion he or she chooses, only if it is necessary to save taxes. Disclaimer trusts offer maximum flexibility where each spouse wishes the other to keep the household's combined property after the first spouse passes away. If you already have a bypass trust and you have a moderate-sized estate (less than \$7 million), you

may wish to consider having your trust changed from a bypass to a disclaimer trust, or you may need to have your bypass trust revised for greater flexibility. This section describes changes in the federal estate and gift tax laws and provides a comparison between bypass trusts and disclaimer trusts.

Tax Reasons for Married Couples to Have a Trust

If a married couple's estate exceeds federal tax thresholds, a trust may help them leave property to family members or others without paying high estate taxes.

The estate tax applicable exclusion amount, which applies to inheritance at death rather than gifts during life, is different and changes periodically. It is \$3.5 million for people who pass away during 2009. (Large gifts made during life, up to \$1 million, can lower what would otherwise be a \$3.5 million estate tax applicable exclusion amount at death.)

The \$3.5 million applicable exclusion amount is of particular concern for members of married couples. For a married couple, if both are U.S. citizens, there is generally no immediately payable tax upon the death of the first spouse, to the extent the first spouse leaves property to the surviving spouse. However, when the surviving spouse also dies, if the surviving spouse's estate contains more than the estate tax applicable exclusion amount, then federal taxes of up to 45% may apply.

Although the surviving spouse may be protected against an immediate tax at the time of the first death, couples who did not take care of estate planning before the first death can lose the advantage of the first spouse's \$3.5 million exemption, with consequences that are postponed until after the second death. The **unlimited marital deduction** allows U.S. citizen spouses to pass unlimited assets to each other upon death, without taxes. However, if one spouse dies without advance estate planning, the couple has lost the use of that spouse's estate tax applicable exclusion amount. That missed opportunity can leave the surviving spouse with a too-large estate resulting in an unnecessarily high tax debt for the couple's heirs. For people who pass away in 2009 and own more than \$3.5 million in real estate or other assets, every dollar over \$3.5 million will be taxed.

It is still possible that a living trust could reduce federal estate taxes for couples whose estates exceed even \$1,000,000, because in 2011 the estate tax applicable exclusion amount is scheduled to decrease to \$1,000,000, unless Congress acts to establish a higher exemption amount.

Example 1: How the Applicable Exclusion Amount Works for Each Individual

If I were to pass away in 2009, and if I had not made any large gifts during my lifetime, then I could own up to \$3.5 million at the time of my death and my estate would not have to pay any federal estate taxes. However, if I owned \$3.6 million, then my heirs would have to pay federal estate taxes of approximately \$41,000 on \$100,000 – the amount I owned beyond \$3.5 million. This would be true regardless of my marital status.

Example 2: Tax Implications of No Estate Planning

Bill and Jane, who are both U.S. citizens, have \$4 million in community property assets. Bill dies in 2009, leaving Jane his entire estate. Because of the unlimited marital deduction, Jane does not owe federal estate taxes at the time of Bill's death. Jane also passes away in 2009, leaving the \$4 million estate. Since the estate tax applicable exclusion amount for 2009 is \$3.5 million, Jane's heirs have to pay estate taxes on \$500,000. If the couple had done some estate planning, they could have eliminated the need to pay this tax.

Changes in the Federal Estate and Gift Tax Law

Federal estate and gift tax levels are in flux. The Economic Growth and Tax Relief Reconciliation Act of 2001 temporarily phased out the estate tax but retained the gift tax. As noted above, the applicable exclusion amount for estate taxes in 2009 is \$3.5 million. For people who pass away during 2010, there will be no federal estate tax imposed on their assets. However, in 2011, the estate tax applicable exclusion amount will return to \$1,000,000 unless Congress acts again. The table below summarizes the federal estate and gift tax scheme for the years between 2009 and 2011. The estate tax is scaled, so the amount of tax varies each year depending on the amount subject to taxation. The chart gives the highest rate for any given year.

Gifts during a donor's lifetime may also face federal taxation. In 2009, an individual may give away \$13,000 to an unlimited number of recipients without gift tax liability and without having to file a gift tax return. However, gifts above \$13,000 per person begin to eat into the \$1 million lifetime gift tax exemption. Any gift exceeding the \$13,000 limit reduces the donor's ability to give tax-free inheritances. For example, if I gave my friend \$23,000 today and I passed away during 2009, my estate would be allowed to convey a further \$3,490,000 free of estate and gift taxes, rather than the usual \$3,500,000, because the \$23,000 gift was \$10,000 beyond the allowable annual limit. (For more information see the helpful IRS primer, "[Frequently Asked Questions on Gift Taxes](#).")

Chart: Tax-free gifts through inheritance allowed for 2009-2011

Calendar Year	Estate Tax Applicable Exclusion Amount (Per Person)	Highest Federal Estate Tax Rate*
2009	\$3.5 million	45%
2010	The estate tax is repealed in 2010, but the gift tax exemption remains \$1 million	None
2011	\$1 million (unless law changes)	55%

** The estate tax rate increases progressively based on the amount subject to taxation. The estate tax rate varies between 41% and the maximum given above for each year.*

Bypass or A-B Trusts

As we've explained, bypass or A-B trusts divide after the first spouse's death into a survivor's trust and a bypass trust. The survivor's trust is usually a revocable trust, which means the survivor may rewrite it in any way, or may revoke it entirely and take direct ownership of its assets. The revocable survivor's trust is therefore treated as the survivor's personal property for tax purposes. By contrast, the bypass trust becomes irrevocable (unchangeable) when the first spouse passes away. Typically, then, the surviving spouse receives income from the bypass trust but has restricted access to the principal of the bypass trust. The deceased spouse's beneficiaries receive the principal of the bypass trust once the surviving spouse has passed away.

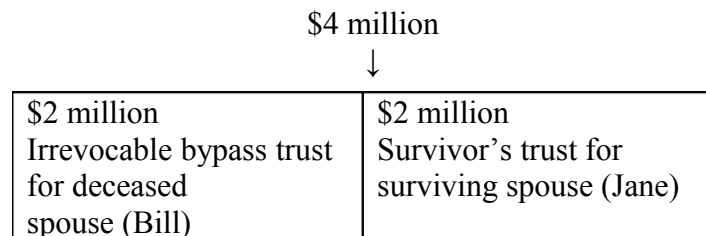
Because the bypass trust for the deceased settlor is irrevocable and hence beyond the surviving spouse's complete control, it is not considered to belong to the surviving spouse for federal tax purposes. Hence at the second spouse's death, no estate tax is imposed on the bypass trust. This is why the bypass trust can reduce or even eliminate estate taxes for married couples. Setting up a bypass trust makes use of the \$3.5 million federal estate tax exemption of the first spouse to die. Without it, the couple would lose the advantage of the decedent's \$3.5 million estate tax applicable exclusion amount.

Here are a couple of examples showing how bypass trusts can help married couples, but also how they can interfere with surviving spouses' access to their savings.

Example 3: Use of a Bypass Trust to Save on Federal Estate Taxes

Bill and Jane have \$4 million in community property assets. Their bypass trust provides for half the estate to pour into the bypass trust upon the first spouse's death, while half the estate remains in the hands of the surviving spouse. Bill passes away in 2009. \$2 million funds the bypass trust for Bill's heirs and \$2 million goes to a "survivor's trust" for Jane. Jane is free to use the \$2 million in her survivor's trust as she pleases. Jane receives the income from Bill's bypass trust, but will have limited access to the principal in the bypass trust.

The following diagram illustrates the split in trust funds:



If Jane passes away later in 2009, Jane's heirs inherit the \$2 million in Jane's survivor's trust, while Bill's heirs inherit the \$2 million in Bill's bypass trust. No federal estate tax is due.

Example 4: Problems of a Bypass Trust

Suppose Bill and Jane have set up a bypass trust as before. In 2010, after Bill passes away, Jane wants to travel. The family home is worth \$2 million and the \$2 million home is in Jane's survivor's trust. The rest of the couple's assets are in Bill's bypass trust. Jane is receiving the income from Bill's bypass trust, but under this type of trust she may have very limited access to the principal. Jane cannot use the principal in the bypass trust to travel.

Several years ago, it made sense for many middle-income people to have bypass trusts drafted in order to save their heirs from paying federal estate taxes. However, older couples who own less than \$1 million, whose assets are invested conservatively, should probably not have a bypass trust if their only objective is to avoid paying estate taxes. (On the other hand, one advantage of bypass trusts is that each spouse can ensure that the surviving spouse will not disinherit the deceased spouse's heirs. This type of trust is particularly useful if one spouse has children from a previous marriage.)

Disclaimer trusts, discussed next, can temper the inflexibility of bypass trusts.

Disclaimer Trusts

Disclaimer trusts can shift assets in response to changing estate tax thresholds and household financial needs. In a disclaimer trust, each spouse leaves his or her share of the estate completely to the surviving spouse. After the first spouse passes away, the surviving spouse holds the power to decide, within nine months after the death, whether the assets should be split. The survivor may choose to keep the whole estate in a revocable Survivor's Trust, which makes everything taxable under the survivor's own Social Security Number. Alternatively, the survivor may "disclaim" some assets so they will flow into a disclaimer trust, potentially reducing federal estate taxes. The disclaimer trust, if created, is structured like a bypass trust in that the surviving spouse receives income from the disclaimer trust, cannot revoke it, has little or no power to change it, and has limited access to its principal. (These separations are still necessary for the disclaimer trust to receive separate tax treatment from the survivor's own property.)

The primary difference between a disclaimer trust and a bypass trust is that, with the disclaimer trust, the surviving spouse still has power after the first death to decide which if any assets to place into the disclaimer trust. The surviving spouse can fund the disclaimer trust only as much as makes sense in light of the federal estate tax structure and the value of assets remaining after the first death. The surviving spouse is not forced to place assets into a disclaimer trust based on assumptions possibly made years before when tax rules were different.

A disclaimer trust does require a high degree of trust between spouses. Because it gives the widow or widower full control over the assets during that nine-month period after the first death, the disclaimer trust does not guarantee any share of the estate to the deceased spouse's heirs or named beneficiaries. However, if both spouses trust that each will not disinherit the

other's heirs or beneficiaries, then the disclaimer trust is an attractive alternative to the bypass trust.

Couples should also consider that the disclaimer trust form requires relatively quick action from the surviving spouse, which can be difficult during the grief process. If the disclaimer trust is to be funded at all, the survivor must take care of the necessary decisions and paperwork within nine months after the first spouse passes away.

Example 5: The Flexibility of a Disclaimer Trust

Returning to Bill and Jane and their \$4 million community property estate, let's again assume Bill passes away in 2009, but now the couple has a disclaimer trust rather than a bypass trust. Bill leaves his share of the estate to Jane. The applicable exclusion amount in 2009 is \$3.5 million. No tax is due at Bill's death because of the unlimited marital deduction.

Jane chooses not to fund the disclaimer trust because she believes she will live until 2010, when the estate tax applicable exclusion amount will be temporarily unlimited. (In doing this, she also presumes that if she lives longer, Congress will not let the applicable exclusion amount fall back to \$1 million in 2011). If Jane passes away in 2009, then failing to fund the disclaimer trust will have been a mistake because \$500,000 of her estate will be subject to federal estate taxes. However if Jane passes away in 2010, assuming the estate is still worth \$4 million, no federal estate tax will be due because the applicable exclusion amount in 2010 is unlimited.

Changing the facts, If Bill passes away in 2010 rather than 2009, and if Jane is alive in 2010, Jane also may choose to not fund the disclaimer trust because if she passes away before 2011 (or if new Congressional action raises the 2011 exemption amount substantially), her estate will not owe any federal estate tax.

In these examples, the flexibility of a disclaimer trust rather than a bypass trust creates significant advantages for Bill and Jane. As with the bypass trust, the surviving spouse (Jane) can use the exemption of the deceased spouse (Bill) if the couple created a disclaimer trust while both were living. But instead of being forced to put money in a bypass trust when the first spouse passes away, the surviving spouse has the option of funding the disclaimer trust at a level that makes sense in light of the tax implications. The surviving spouse can therefore use the entire estate to travel, buy another home, give gifts to loved ones, donate money to charity, etc.

As we mentioned above, if you had a bypass trust drafted before the early 2000's you may wish to consult an attorney to determine whether it is still the right type of trust for you. If you would like to meet with us, the initial half-hour consultation in preparation for an estate plan is free of charge.

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