WRMarketplace
An AALU Washington Report

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TOPIC: Fundamentals of Core Legacy Planning – The Importance of Revocable Living Trusts.

MARKET TREND: The use of revocable trusts is on the rise, and here's why: flexibility, asset management, and privacy.

SYNOPSIS: Revocable living trusts ("RLTs") are often the cornerstone of a core legacy plan. A well-constructed RLT offers many benefits, including asset management during incapacity, probate avoidance, creditor protection, and legacy transfer planning. RLTs also define how an individual's assets are to be distributed following his or her death and can be structured in many ways, from the simplicity of outright distributions to the complexity of comprehensive dynasty trusts. An understanding of the various basic RLT structures can help advisors and clients select the optimal RLT structure for the client's circumstances.

TAKE AWAYS: Structuring an effective RLT requires careful analysis of the client's assets and legacy planning goals and how the proposed structure fulfills those goals. Since family dynamics, transfer taxes and other circumstances change constantly, core legacy plans, particularly the RLT, should be reviewed and updated regularly.

PRIOR REPORTS: 16-34

An RLT is the cornerstone of a core legacy plan and can offer numerous benefits:

- Planning for estate and generation-skipping transfer ("**GST**") taxes;
- Asset management during incapacity;
- Avoidance of the costs and delays of probate proceedings;
- Privacy for both the trust assets and the dispositive plan;
- Easy asset transition at death; and
- Asset protection for the settlor's spouse and other beneficiaries.

An understanding of the various basic RLT structures and the associated benefits and issues can help advisors and clients select the optimal RLT structure for the client's circumstances.

MEET THE CLIENTS: SAM & EMMA

To illustrate the various RLT structures and their differences, assume that Sam and Emma have been married for 35 years and live in a non-community property state. Sam, through his career and a family inheritance, has accumulated an estate of nearly $5.5 million. Emma has relatively few assets. Sam would like to set up an RLT as part of his legacy plan to ensure continued asset management in the event of incapacity and to streamline probate issues for his family after he passes.[1] Sam and Emma would both like to defer estate taxes until the passing of the surviving spouse, to the greatest extent possible.

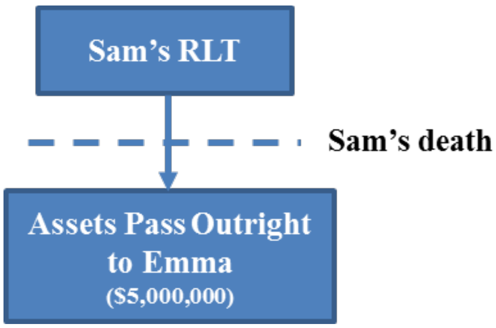
While all RLT structures avoid probate and provide continued asset management in the event the "settlor" (i.e., the creator of the trust) becomes incapacitated (as long as the RLT is properly funded), the selection of the RLT structure that best meets a client's needs will depend upon the anticipated value of the client's estate, family circumstances, and legacy planning goals.

BASIC RLT STRUCTURES

Simplicity for Smaller Legacy Plans: The "A" Trust - Outright to the Surviving Spouse

The most basic RLT structure leaves everything outright to the settlor's spouse,[2] if he or she survives, otherwise the trust assets either pass outright to the settlor's descendants (or other beneficiaries) or remain in trusts for their benefit.

> *Example*: Sam creates an RLT providing that, upon his death, all of the assets in the RLT pass outright to Emma or, if Emma is deceased, to their descendants.



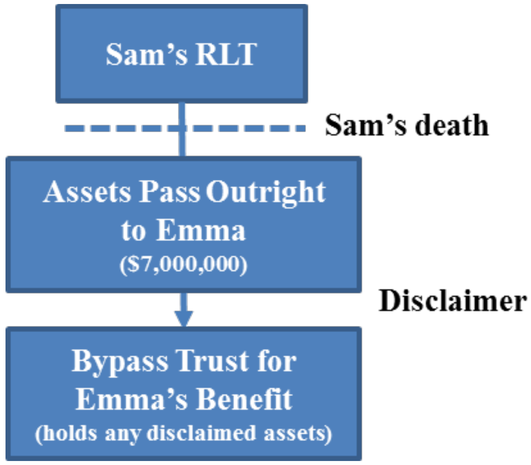
The “A” trust structure is generally used for smaller estates that will be subject to relatively little or no estate tax, with consideration of the following:

Advantages	Disadvantages
• Simple • Qualifies for estate tax marital deduction, deferring estate taxes until Emma's death • Sam's federal estate tax exemption can be “ported” to Emma to use either for lifetime gifts or at her death[3]	• Sam's assets (including appreciation after his death) will be included in Emma's estate • No creditor protection • Emma has full control over inherited assets and can leave them to anyone she wishes, including a new spouse should she remarry

Optional Tax Planning for Mid-Size Legacies: The AB Disclaimer Trust – Outright to Surviving Spouse - Disclaimed Assets to “Bypass” Trust

Like the “A” trust structure, a so-called “AB disclaimer trust” also leaves everything outright to the surviving spouse. However, if the surviving spouse makes a “qualified disclaimer”[4] of all or part of the bequest, the disclaimed assets instead pass to a so-called “**bypass trust**” (or “**credit shelter trust**”) designed to use the decedent's remaining federal estate tax exemption for the spouse's benefit and, if desired, for the settlor's descendants. After the surviving spouse's death, the remaining bypass trust assets pass to the settlor's descendants (either outright or in trust).

> *Example*: Assume Sam has an estate of $7,000,000, and Emma has an estate of $4,000,000, for a total estate of $11,000,000. Sam's RLT leaves all the trust assets outright to Emma at Sam's passing. If Emma disclaims any part of the bequest, those assets will pass to a bypass trust benefiting Emma and her and Sam's descendants. On Emma's death, any remaining bypass trust assets will be divided into shares and held in separate trusts for their descendants.



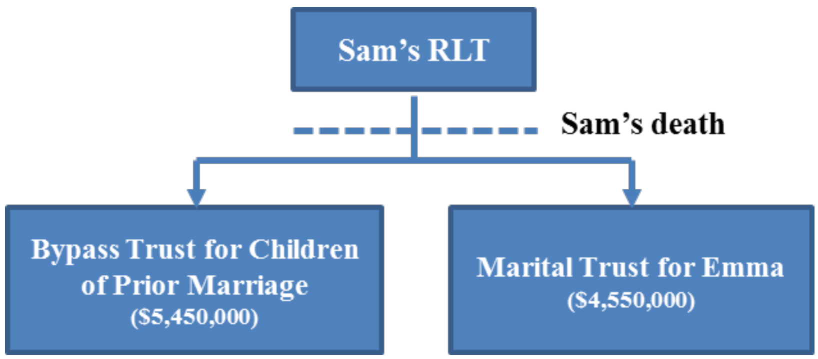
AB disclaimer trusts are generally used for moderate-size estates, where there is the possibility of an estate tax at the later death of the surviving spouse. They have the same advantages as "A" trusts, with the following additional considerations:

Advantages	Disadvantages
• Emma can evaluate the circumstances at Sam's death to determine whether to disclaim • The assets passing to the bypass trust, including the appreciation on such assets, will not be subject to estate tax on Emma's death • Emma can still benefit from the disclaimed assets/bypass trust for her lifetime • The bypass trust provides creditor protector • Emma could serve as trustee of the bypass trust (but her distributions powers must be limited to an ascertainable standard (e.g., health, education, maintenance and support)) • At Emma's death, bypass trust assets pass to Sam's intended beneficiaries – Emma cannot leave the assets to a new spouse or others	• More complex than the "A" Trust • Assets not disclaimed (plus appreciation) will be included in Emma's estate • No creditor protection for assets Emma receives outright • Emma has full control over assets she receives outright and can leave them to anyone she wishes, including a new spouse if she remarries • A qualified disclaimer must be made within 9 months of Sam's death • To ensure a qualified disclaimer, Emma cannot have a power of appointment over the assets in the bypass trust during her lifetime or upon her death

Larger Legacies: The AB Trust – Assets to Bypass Trust and Marital Trust

The "AB" trust structure builds on the AB disclaimer trust and is particularly common for estate tax planning, particularly when the settlor has children of a prior marriage or creditor protection is a goal. At the settlor's death, assets are automatically allocated to a bypass trust and marital trust rather than leaving the decision to the surviving spouse.

> *Example*: Assume Sam's estate is valued at $10,000,000, and he has two children from a prior marriage. Sam's RLT provides that, upon his death, an amount equal to his remaining federal estate tax exemption ($5,450,000) will pass to a bypass trust benefiting his descendants from his prior marriage. The balance of Sam's estate ($4,550,000) will pass to a marital trust for Emma's benefit. Upon Emma's death and after payment of estate taxes on the marital trust assets,[5] those remaining assets pass to the descendants of Sam and Emma's marriage.



AB trusts are often used for larger estates, where estate tax considerations play a more significant role. They have many of the same advantages as AB disclaimer trusts, along with the following:

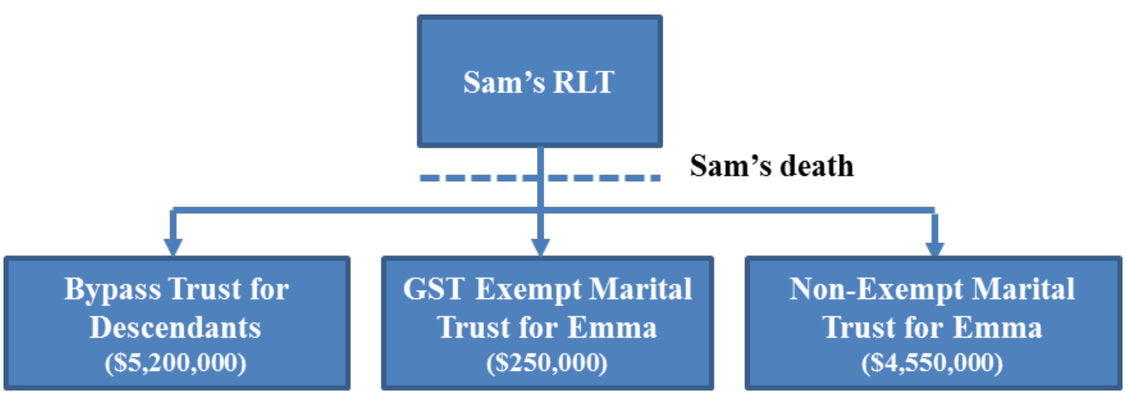
Advantages	Disadvantages
• Ensure full use of Sam's remaining federal estate tax exemption • Emma can benefit from both trusts • Both trusts can offer creditor protection • Emma can serve as trustee of both trusts subject to an ascertainable standard for distributions • Emma can hold a power of appointment over both trusts to increase flexibility • At Emma's death, assets in both trusts pass to Sam's intended beneficiaries, not Emma's	• No flexibility to decide if assets should pass outright or be disclaimed • Added complexity and administrative costs for two trusts • After Sam's death, the structure is irrevocable and cannot be changed (although Emma can be given a power of appointment to add flexibility) • Emma's access to trust assets is more restricted than to outright distributions

<u>The Sophisticated Tax and Creditor Planning Alternative: ABC Trusts</u>

The "ABC" trust structure is typically used when long-term dynasty trusts are to be created for the settlor's descendants. This type of structure builds on AB trusts by adding an additional marital trust to use any remaining GST tax exemption (a so-called "**GST exempt marital trust**") after allocation to the bypass trust. While the settlor's spouse is the only beneficiary of the two marital trusts, the spouse and/or descendants may still benefit from the bypass trust.

Following the surviving spouse's death, any remaining assets in the bypass trust and the GST exempt marital trust pass to GST exempt dynasty trusts for the settlor's descendants and can continue for multiple generations without transfer taxes. The balance of the non-exempt marital trust also can continue in trust for the settlor's descendants, however, those assets will incur either estate or GST taxes at each generation.

> *Example*: Assume Sam has made lifetime taxable gifts of $250,000 to his children and has $10,000,000 remaining in his estate. He would like to create dynasty trusts for his descendants after he and Emma pass. Sam's RLT provides that, upon his death, an amount equal to his remaining federal estate tax exemption of $5,200,000 ($5,450,000 less $250,000 of lifetime use) passes to a bypass trust for his children (including the children of his prior marriage). Part of Sam's GST tax exemption - $5,200,000 - will be allocated to the bypass trust.
>
> The balance of Sam's estate ($4,800,000) will pass to two marital trusts – $250,000 to a GST exempt marital trust and the balance ($4,550,000) to a non-exempt marital trust. Sam's unused GST tax exemption ($250,000) will be allocated to the GST exempt marital trust.
>
> Upon Emma's death (and after payment of estate taxes on the assets in both marital trusts) the remaining assets in the bypass and GST exempt marital trusts will pass into separate GST exempt dynasty trusts for Sam's descendants. The balance of the non-exempt marital trust will also be held in non-exempt dynasty trusts for Sam's descendants (subject to a transfer tax at each generation).



The ABC Trust structure has the same advantages and disadvantages of the AB Trust, with the additional benefit of allowing Sam to take full advantage of the GST tax exemption to address transfer taxes and maximize creditor protection through the use of dynasty trusts.

TAKE AWAYS

- Structuring an effective RLT requires careful analysis of the client's assets and legacy planning goals and how the proposed structure fulfills those goals.

- Since family dynamics, transfer taxes, and other circumstances change constantly, core legacy plans, particularly the RLT, should be reviewed and updated regularly.

DISCLAIMER

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NOTES

[1] In a community property state, spouses generally will establish a joint RLT to hold all of their assets (as opposed to one for each spouse to hold their respective assets). On the death of the first spouse, the surviving spouse's assets are allocated to a so-called "survivor's trust," while the deceased spouse's assets are allocated in accordance with one of the trust structures described below.
[2] In a joint RLT created in a community property state, typically all of the deceased spouse's assets and the survivor's assets would pour into a survivor's trust. The survivor would have full control of the assets as if he or she had received the assets outright.
[3] Note, however, that if Emma remarries, Sam's unused federal estate tax exemption could be lost if her new spouse dies first.
[4] A disclaimer is the refusal to accept an interest in a gift, bequest or inheritance. If the disclaimer meets the requirements of a "qualified disclaimer" under Internal Revenue Code ("Code") § 2518, the decedent rather than the surviving spouse is treated as the transferor for estate, gift and GST tax purposes. A qualified disclaimer must meet the following requirements: (1) it must be made in writing and delivered to the trustee or the decedent's executor, (2) it must be made within 9 months after the decedent's date of death, (3) the person making the disclaimer cannot have accepted any interest in or benefit from the disclaimed assets, and (4) the interest must pass, without any direction on the part of the person making the disclaimer, to the spouse of the decedent or to a person other than the person making the disclaimer.
[5] Note that, in situations involving such planning for a blended family, consideration should be given to how estate taxes at the surviving spouse's death should be allocated (i.e., apportioned), among the descendants of the prior marriage and the descendants of the settlor's most recent marriage. See *WRMarketplace No. 16-40* for a more detailed discussion of estate tax apportionment issues.

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