Dividing A Trust Into Subtrusts

After A Spouse's Death

Funding Separate Subtrusts Created under a Trust

A. **Overview:** This memo is directed to the trustee of a revocable trust where the trust requires the allocation of trust assets into two or more subtrusts at the time of the settlor's death, or, in the case of a two-settlor trust, at the time of the settlor who dies first ("deceased settlor" or "decedent"). Traditionally, this type of planning has been done by married couples, but it also works for domestic partners and unrelated individuals; however, planning involving a trust that qualifies for the marital deduction for federal estate tax purposes does not apply if the surviving settlor is not married (as defined under federal law) to the deceased settlor.

A.1 Purpose of Division. The division of a trust is frequently tax motivated, but it can also be required because of a desire to preserve assets for specific beneficiaries (such as the children of the deceased settlor), and/or a desire to protect assets against the claims of creditors and the impact of divorce and re- marriage.

A.2 Federal Estate Tax. The federal estate tax rate is 40%.[1] The amount of property that can be transferred free of the estate tax is referred to as the "applicable exclusion amount", which was $11,580,000 in 2020 and is $11,700,000 in 2021.[2]

A.3 Note of Caution. This memo speaks in general terms and refers to trust provisions that are typical. This memo was not written with any specific trust in mind. Each trust is unique, and you should read the trust documents carefully and confer with a CPA or with us or another attorney who is experienced in trust administration and estate tax matters. This memo does not discuss your duties to administer the subtrusts after they are created and funded. For that, you should read the memo titled "Your Duties as Trustee".[3]

B. **Two-Settlor Trusts:** Most of the two-settlor trusts that require a division when one settlor dies are designed either as an "A/B Trust" or as an "A/B/C Trust".

B.1 A/B Trust. Upon the decedent's death, the typical "A/B Trust" is divided into two subtrusts, which are labeled as the "Survivor's Trust" and the "Decedent's Trust" in Figure 1. It is called an A/B Trust because the Survivor's Trust is referred to as Trust A, and the Decedent's Trust is referred to as Trust B.[4]

(a) *Survivor's Trust*. The "Survivor's Trust" or "Trust "A" receives all of the surviving settlor's assets plus the decedent's assets to the extent the value exceeds the "applicable exclusion amount". In most cases, the surviving settlor will have the right to amend and

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[1] The maximum rate imposed for federal estate tax purposes is currently 40%. For the rates in prior years, see https://rushforthfirm.info/advintro.html#ae.

[2] Internal Revenue Code § 2010(c) provides for an "applicable exclusion", which is the cumulative amount that can pass free of gift and/or estate tax. For the applicable exclusion in prior years, see https://rushforthfirm.info/advintro.html#ae.

[3] This is available online at https://rushforthfirm.info/pdf/trustee.death.pdf.

[4] Many trusts do not use the Trust A and Trust B designations, but it is still common to refer to these trusts as "A and B Trusts". Memory aid: The survivor's trust (Trust A) is for the spouse that is Alive, and the marital trust (trust B) is for the settlor that is Buried.

revoke the "Survivor's Trust". This trust is usually designed to qualify for the estate tax marital deduction if the settlors are married at the time of the first death of a settlor.

(b) *Decedent's Trust*. The Decedent's Trust[5] or Trust B receives as much of the deceased settlor's property that can pass free of the estate tax.[6] This is done primarily so that the decedent's "applicable exclusion amount" is preserved without further estate taxation and without being subject to the claims of a beneficiary's creditors or to dissipation in a beneficiary's divorce proceeding. The surviving settlor may be (and usually is) the beneficiary of the Decedent's Trust, and the trust may permit the surviving settlor to direct distributions from the trust either during the surviving settlor's lifetime or after the surviving settlor's death or both.

B.2 A/B/C Trust. An A/B/C trust is only for couples who are married (as defined in federal tax law).[7] Upon the decedent's death, the typical "A/B/C Trust" or "A/B/QTIP" divides into three subtrusts. (See Figure 2.)

(a) *Survivor's Trust*. In a typical "A/B/C Trust", the "Survivor's Trust" or "Trust A" is a trust for the surviving settlor's assets, and the surviving spouse has the right to designate who will be its beneficiaries upon the survivor's death. This trust receives all of the surviving settlor's assets but none of the decedent's assets.

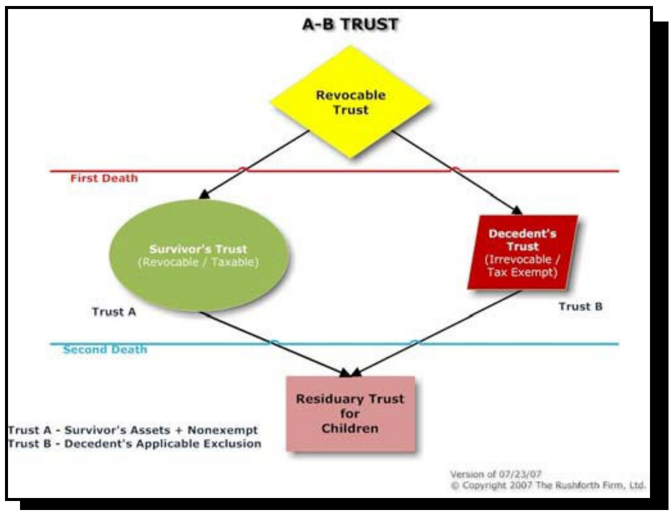

Figure 1

(b) *Decedent's Trust*. In an "A/B/C Trust", the "Decedent's Trust" or "Trust B" is an irrevocable trust that receives assets that are covered by the "applicable exclusion". This is usually drafted as a spendthrift trust that is exempt from the claims of the surviving spouse's creditors.

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5 Although this memo refers to the "Decedent's Trust", it may be named something else in your trust documents. Common names include "Credit-Shelter Trust", "Bypass Trust", "Exemption Trust", and "Exclusion Trust".

6 This is the "applicable exclusion amount" that has not been used for lifetime gifts. The "applicable exclusion amount" is given in note 2 at the bottom of page 1.

7 While Nevada's domestic partnership laws give domestic partners exactly the same rights as married couples, current federal tax law does not recognize domestic partners as being married. Same-sex marriages are recognized.

(c) *Marital Trust*. The "Marital Trust" or "Trust C" is an irrevocable trust that qualifies for the marital deduction. The Marital Trust is most commonly a "Qualified Terminable Interest Property Trust" (often called a "QTIP Trust")[8], but it can be a life estate/general power of appointment trust.[9] Under either type of marital trust, the surviving spouse is entitled to all of the trust's income each year and may permit the invasion of the trust's principal for the surviving spouse's benefit. Neither type of marital-deduction trust permits anyone other than the surviving spouse to receive distributions from the trust during the surviving spouse's lifetime.

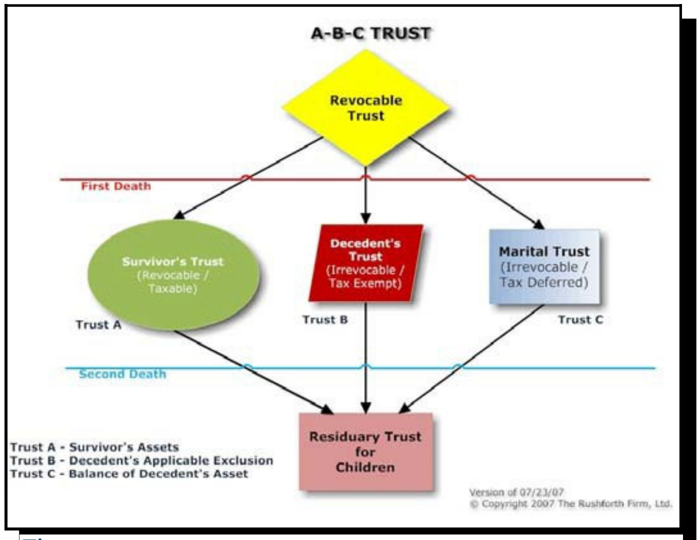

Figure 2

(i) The QTIP trust may permit the surviving spouse to direct distributions from the trust after the surviving spouse's death.

(ii) The life estate/general power of appointment Marital Trust requires that the surviving spouse have the power to direct distributions from the trust at his or her death.

C. **Division of One-Settlor Trust:** In the case of a one-settlor trust, the trust is commonly divided between a Decedent's Trust and a second trust, such as a Marital Trust or a Survivor's Trust, in a manner similar to the division of a two- settlor trust as described in section B, above. While a Survivor's Trust is usually revocable, that is frequently not true in a one-settlor trust.

D. **Trust Allocation Formulas:** Under both an A/B trust and an A/B/C trust, upon the death of the decedent, the trust must be divided into the trusts as directed in the trust document. Sometimes, specific assets are allocated to the different trusts, but usually the trust is divided according to a stated formula. Each type of formula produces slightly different results with respect to asset allocations and income tax consequences. ***It is important for the trustee to follow the provisions of the document relating to asset allocations and to document what has been done. It will also be important to maintain accurate records of the subtrusts until the surviving settlor dies.***

D.1 Fractional Formula. The formula can provide for a division of the trust into "fractional shares" so that each trust owns a fractional interest of each asset.

[8] If a QTIP Trust is used, the trust may be referred to as an "A/B/QTIP Trust" or an "A/B/Q Trust".

[9] This type of trust is often called a "B5 trust" because it is described in IRC § 2056(b)(5).

(a) The advantage of this formula is that the division is a mathematical division that appears in the trust's accounting records, but specific asset allocations are unnecessary. The disadvantage of this method is the need to have your accountant update the fraction every time you distribute assets from one of the subtrusts.

(b) In many documents that use a fractional formula, the trustee is given the authority to satisfy the fraction using a "non pro rata" allocation of assets. This allows the trustee to "pick and choose" specific assets to make up the values that should go to each subtrust. If the pick-and-choose option is available under the terms of the trust instrument, we strongly recommend that this option be used. This will eliminate the need to update the fraction after distributions are made from one or more of the trusts.

D.2 Pecuniary Formula. The pecuniary formula can provide for an allocation of assets based on an amount of money ("pecuniary amount"). Certain versions of this formula can provide for greater flexibility in allowing growth assets to benefit the Decedent's Trust, but if there is substantial post-death appreciation on certain assets, the allocation of assets to a subtrust can actually trigger an income tax on capital gains.

E. **Procedure:** The division of the trust is based on the fair market value of the trust assets at the time of the decedent's death or at the time the trust allocations are made, depending on the terms of the trust instrument. Documents commonly usually require the use of values "as finally determined for estate tax purposes", which are date-of-death values (with a few exceptions). If the trust allows the trustee to select a valuation date, it is often advisable to use the estate-tax valuation date in order to reduce the need for additional appraisals.

E.1 Appraisal. Formal appraisals of real property, valuable collectibles, jewelry, and closely held business interests are highly recommended. Appraisals by qualified appraisers are the best defense against subsequent attacks by the IRS or disgruntled beneficiaries. In addition to establishing values for purposes of asset allocation, appraisals also establish the income-tax basis for purposes of computing the gain on the sale of capital assets. In other words, the date-of-death value is treated as the cost of all of the decedent's separate property and for all community property, including the surviving spouse's half.

E.2 Selecting Assets. Once the assets are appraised, the next step is to decide which assets are to be allocated to each trust. If a fractional formula applies, there still may be assets that are specifically allocated to one trust or another, and so it is important to follow the legal documents. If one or more specific assets are to be allocated to one or more specific trusts, the trustee should consult with an accountant and investment advisors before deciding which assets should go into which trust. There are estate and income tax issues to be considered. If the survivor is not the trustee, the trustee must carefully consider the survivor's rights, and consulting with the survivor is advisable.

(a) *Expenses, Taxes, and Income*. The trust document will usually contain detailed and somewhat complicated rules for the allocation of expenses, taxes, and income between or among the various subtrusts. Failure to follow the directives of the document can expose the trustee to criticism or even litigation and can expose the trust to unexpected or undesirable tax consequences.

(b) *Postmortem Appreciation or Depreciation.* Assets will appreciate or depreciate between the date of death and the date the assets are actually allocated to the various subtrusts. Unless your trust uses a fractional formula that allocates fractional shares of all assets between or among the subtrusts, your trust requires that the appreciation and depreciation be fairly apportioned between or among the trusts.

(c) *Splitting Asset Ownership.* The ownership of assets can be divided between or among multiple trusts. For example, each trust can own different shares of a business or different percentage in a parcel of real estate. If the Survivor's Trust or Marital Trust have a minority interest in a business or a fractional interest in real estate, the estate tax value in the survivor's estate might be reduced because of a valuation "discount" that an appraiser will apply in appropriate circumstances. Keep in mind, however, that splitting the ownership of an asset can complicate matters if the trusts have different trustees and/or different beneficiaries.

(d) *Income Tax Issues.* The Survivor's Trust is usually revocable or contains a general power of appointment allowing the survivor to change trust beneficiaries. This makes the survivor's trust a "grantor trust" for federal income tax purposes, which means that all income will be taxed to the survivor. It also means that any tax benefits available to an individual — such as the exclusion of capital gain on the sale of a primary residence under Internal Revenue Code ("IRC") § 121 — will pass through to the survivor. The assets in the Decedent's Trust will escape estate taxation upon the survivor's death, making this an attractive trust into which appreciated assets should be allocated, but a sale of assets from the Decedent's Trust will not escape capital gain taxes if there has been appreciation after the first spouse's death. With respect to a home sale, the IRC § 121 exclusion will not apply to any interest in the home allocated to the Decedent's Trust.

(e) *Unproductive Assets.* Assets in a QTIP trust cannot benefit anyone other than the surviving spouse, and, at a minimum, the surviving spouse is entitled to trust income from the Marital Trust, regardless of the type. Federal law allows the survivor to compel the trustee to make unproductive property income-producing, so allocating unproductive property to the Marital Trust is not appropriate unless the survivor consents.

E.3 <u>Record of Division</u>. It is the trustee's responsibility to see that assets are properly allocated to the various subtrusts. Once a value has been established for the trust's assets, it is important to document the required division into the subtrusts. In most cases, this will require a coordinated effort of both your accountant and your trust attorney. The trust document contains detailed and somewhat complicated rules for the allocation of expenses, taxes, and income between or among the various subtrusts. Failure to follow the directives of the document can expose the trustee to criticism or even litigation and can expose the trust to unexpected or undesirable tax consequences.

E.4 <u>Asset Transfers</u>. Most trust documents do not require that the legal title to assets be specifically transferred to the subtrusts; title can remain in the name of the trustee of the primary trust so long as the trust's accounting records accurately reflect each subtrust's property interests. On the other hand, if the subtrusts have different trustees, it is usually advisable to transfer legal title to the trustee(s) of each subtrust. We recommend re-titling assets in the name of each subtrust in almost all cases.

F. **<u>Generation-Skipping Transfer Tax</u>:** The federal government has established a generation-skipping transfer tax ("GSTT") that is imposed when assets are transferred from a transferor to a "skip person", who is anyone who is in any generation below a child, including grandchildren, great- grandchildren, etc. There is a "GST Exemption" that exempts transfers from the GSTT. The GST Exemption is the same as the applicable exclusion for gift- and estate-tax purposes.[10] To maximize the effectiveness of the GST Exemption, many trusts permit or require that trusts be divided into GSTT-exempt and GSTT-nonexempt trusts. Without going into the details of why, it is important to follow the trust's provisions relating to the creation of subtrusts. Generally, the same principles that apply to the division of the trust into the Marital Trust, Decedent's Trust, and Survivor's Trust also apply into dividing those trusts into exempt and nonexempt trusts for generation- skipping transfer tax purposes.

G. **<u>Disclaimer by Surviving Settlor</u>:** Most trusts for married couples are designed to eliminate estate taxes upon the death of the first spouse to die. This defers all estate tax until the surviving spouse's death. Unfortunately, this can push the overall estate into higher estate tax rate brackets. Under prior law, it was sometimes advisable, for the surviving spouse to disclaim part of the Marital Trust, allowing it to be taxed at lower brackets. Unless and until the law is changed, for estates exceeding the applicable exclusion, there is only one tax rate (40%), so disclaiming more than that may not save estate taxes. If the surviving spouse disclaims assets, the disclaimed portion will pass as is provided in the trust document. Disclaimed assets are usually distributed as though the surviving spouse had died, but the trust instrument may instead direct that such assets be held in a special Disclaimer Trust established for the survivor's benefit. Disclaimers are another tool that can save taxes if used effectively, but they should be used only after considering all of the implications.

H. **<u>Estate Tax Return</u>:** If the decedent's assets (all separate property plus half of any community property) have a value greater than the exemption amount, a federal estate tax return (IRS Form 706) must be filed within nine months of the decedent's death even though no estate tax is due. If the Marital Trust is a "QTIP trust", the 706 should be filed to make the "QTIP election", even if no tax is due.

H.1 The values shown on this tax return must jibe with the values used to allocate assets between or among the subtrusts. If the values are not identical, they must be reconciled. It is important that the value claimed as a marital deduction on the estate tax return correspond with the value of assets in the Marital Trust plus the value of other assets transferred to the surviving spouse. It is also important that the value of each GSTT-exempt trust created for generation-skipping transfer tax purposes match the GST Exemption allocated to that trust on the estate tax return.

H.2 If the available applicable exclusion exceeds the value of the taxable estate of the deceased spouse, the unused exclusion can be made available for the surviving spouse to use in his or her estate. To do that, an election known as the "DSUE" (i.e., "deceased spouse's unused exemption") election must be made, and an estate tax return must be filed to make that election.

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[10]The federal generation-skipping transfer tax ("GST tax") is imposed at the highest rate imposed for federal estate tax purposes, which is shown in note 1. For 2011 and beyond, the GST exemption has been the same as the applicable exclusion for estate tax. (See note 2.)

H.3 We strongly recommend that you retain a qualified and experienced certified public accountant to prepare the estate tax return. While the estate tax return itself does not appear too complicated, a properly prepared return will include copies of supporting documents, including copies of appraisals, trust documents, the deceased spouse's Will, etc.

I. **<u>Income Taxes</u>:** After the death of the decedent, the trustee is required to obtain a tax identification number for each trust other than a grantor trust (as defined in federal income tax laws).

I.1 <u>Irrevocable Trusts</u>. The Decedent's Trust and any Marital Trust are irrevocable trusts, and each requires its own tax identification number. Each year, the trustee must file a fiduciary income tax return (IRS Form 1041) for each irrevocable trust, providing a schedule K-1 to each beneficiary receiving trust income (as defined in federal tax law).

(a) The distribution of income to the surviving spouse is mandatory as to the Marital Trust, which means that the surviving spouse will report all Marital Trust income on his or her individual income tax return (IRS Form 1040), in which case the trust itself would pay no income taxes.

(b) The same is true for income from the Decedent's Trust if the trust requires income to be distributed to the survivor. On the other hand, if the Decedent's Trust permits the accumulation of income or permits income to be distributed to other beneficiaries, the trust will pay the tax on any income it accumulates, the surviving settlor will report the income he or she actually receives, and each other beneficiary will report the income he or she actually receives.

I.2 <u>Survivor's Trust</u>. The Survivor's Trust is usually revocable, and so the tax identification number for the Survivor's Trust can be the surviving spouse's social security number so long as the surviving spouse is serving as the sole trustee of the trust. Until the survivor's death, all income from the assets in the Survivor's Trust will be reported each year on the survivor's individual income tax return (IRS Form 1040).

J. **<u>Updating the Inventory for Each Subtrust</u>:** The inventory of each subtrust's assets should be kept current. If specific assets are allocated to each subtrust, it is recommended that a separate supplemental schedule be prepared regularly for each subtrust. If the trust was divided into fractional shares, the trust allocation is updated by recalculating the fraction each time distributions are made, as well as each time income is allocated to principal. Distributions to beneficiaries, gifts, sales, exchanges, and other transfers will change the assets or the undivided interest allocated to each subtrust.

K. **<u>Failure to Divide into Subtrust</u>:** When a trust agreement requires the division of the trust into subtrusts, and the trustee fails to make the division, there can be negative consequences. If the subtrusts have different beneficiaries (such as children from prior marriages), the beneficiaries' respective rights may be difficult to determine, and lawsuits can arise. The Decedent's Trust and the Marital Trusts are irrevocable spendthrift trusts that are protected against the claims of the beneficiaries' creditors. Failure to properly allocate assets to those trusts may make them vulnerable to creditors' claims. The Decedent's Trust is exempt from estate taxation upon the survivor's death. If it has not been properly established, the exemption may be unavailable. Tax laws can change, and the exclusion amounts can be diminished. It is important to preserve the exclusion whenever possible.

L. **<u>Conclusion</u>:** To preserve the estate tax planning that was designed into your trust, it is important for the trustee to meticulously follow the trust's provisions relating to the division of the trust into subtrusts. The trustee has a duty to make a complete inventory of all trust assets, determine the value of trust assets, and allocate assets to the subtrusts according to the document's formula based on the assets' value. It is important to file annual tax returns for each irrevocable trust and to keep asset allocations up-to-date and properly documented so that each subtrust's assets or property interests are clearly segregated and identifiable.

NOTE: This memo provides general information only and does not contain legal, accounting, or tax advice. For brevity, this memo is oversimplified and should not be relied on for any particular situation. For situation-specific tax advice that you can rely on, you should consult an experienced attorney or certified public accountant.

RUSHFORTH FIRM LTD.
5550 Painted Mirage Road, Suite 320, Las Vegas, NV 89149-4584
702-255-4552 (Office) | 702-255-4677 (Fax)
office@rushforthfirm.com
https://rushforthfirm.com | https://rushforthfirm.info

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