

# *AB Disclaimer Trust: Is It For You?*

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**PROBLEM:** Due to changes in federal estate tax laws, married couples with AB or ABC Trusts (containing mandatory sub-trust funding provisions) should consider amending and restating their trust to an AB Disclaimer Trust to avoid unnecessary complexity and administration expense at the death of the first spouse. This only applies to married couples who agree that the survivor may have the power to change everything.

**SOLUTION:** Amend and restate your living trust (have a new complete living trust drafted with new date to replace your existing one) to an AB Disclaimer. You will NOT need to re-title your assets that are already titled in the name of your trust. When needed, it must be completed before the death of the first spouse.

**DO I NEED IT?** That depends on you. AB and ABC Trusts still work as designed. But after you understand the pros and cons of the different trust types, and if you agree that the survivor may have the power to change everything, then you may prefer the characteristics of an AB Disclaimer Trust. In that case, you should make the change.

The AB Trust *type* is a common Revocable Living Trust among estate planners for married couples and is the foundation estate planning document for most. I specify AB Trust “*type*” because there are several types of AB Trusts. Regardless of type, these trusts have two major functions: (1) to keep your estate out of probate during your lifetime and at death, and (2) to guarantee the use of both spouse’s federal estate tax exemptions (hereafter “*exemption*”), if needed, thereby reducing or eliminating federal estate tax.

During 2001, President Bush signed tax legislation that phased out the federal estate tax effective January 1, 2010. However, due to the bill’s “*sunset provision*,” that *repeal* expired on December 31, 2010, causing the old estate tax law (with a \$1,000,000 exemption and a maximum 55% tax rate) to return. Congress enacted new laws, and the current exemption was set retroactively for 2010 and for 2011 at \$5,000,000 per person, with a maximum federal estate tax bracket of 40%. The exemption is now also indexed for inflation (\$5.34 million for 2014). Another recent major development starting in 2011 is the new ability for surviving spouses *to take for their own future use* any unused exemption of their last predeceased spouse, commonly called the “*DSUE*”, **but only if the surviving spouse files a timely federal estate tax return (IRS Form 706) for the deceased spouse’s estate.**

Primarily due to these law changes, the trust of choice for married couples has become the AB Disclaimer trust. In fact, virtually all of the trusts that I now draft for married couples is the AB Disclaimer trust. To understand the difference between the AB or ABC trust and the AB Disclaimer trust, compare Figure 1 and Figure 2 below. During the joint lifetimes of both spouses, all of your retirement accounts stay in your name, and your trust assets are titled in the name of your trust. This is the same for all types of AB or ABC trusts, including the AB Disclaimer trust. The difference is what happens at the death of the first spouse.

With an AB trust, half of the trust assets are funded in to the A trust, also known as the Survivors Trust, and the other half of the trust assets are funded into the B trust, also known as the Exemption Trust, up to the amount of the estate tax exemption (E) in force in the year of the death of the first spouse. If the half that is being funded into the B trust exceeds the estate tax exemption (E) in effect in the year of the death of the first spouse, then the overflow is funded into the A trust. Therefore, it is possible that the A trust will be larger than the B trust. The ABC trust works similarly, except that the overflow from the B trust is funded into the C trust instead of the A trust. With an AB Trust, the surviving spouse's exemption (E<sub>ss</sub>) covers the retirement accounts and the A trust. With an ABC Trust, the surviving spouse's exemption (E<sub>ss</sub>) covers the C trust as well. The deceased spouse's exemption (E<sub>ds</sub>) covers only the B trust in both the AB and ABC Trust.

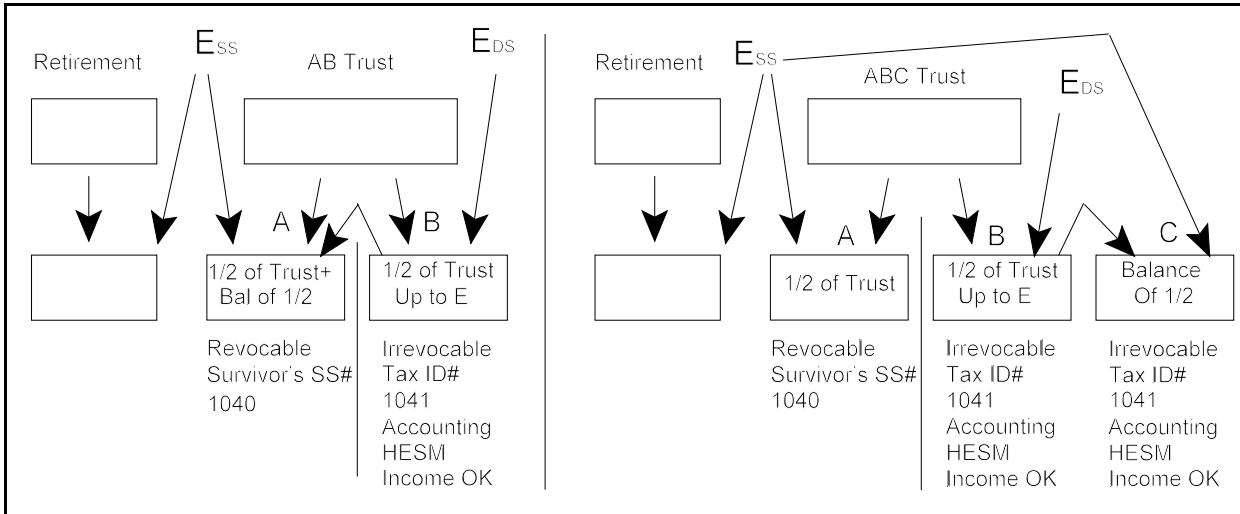


Figure 1: AB and ABC Trust Diagram

The following statements are true about the A trust.

1. The A trust is revocable, and the surviving spouse has the power to change everything.
2. The surviving spouse can spend the A Trust assets without restriction, for anything desired.
3. The tax identification number for the A trust is the surviving spouse's social security number.
4. The surviving spouse declares taxable income on a IRS Form 1040 as if the trust did not exist.

The following statements are true about the B and C trusts.

1. The B and C Trusts are irrevocable, and the surviving spouse cannot change the successor trustee or the beneficiaries.
2. The B and C Trusts must obtain their own tax identification numbers from the IRS.
3. The B and C Trusts must file an IRS Form 1041 every year for the life of the surviving spouse.
4. The surviving spouse must give a copy of the B and C Trusts to all the B and C Trust beneficiaries.
5. The surviving spouse must give an accounting annually to B and C Trust beneficiaries upon request.
6. The surviving spouse is generally entitled to receive the income from the B and C Trusts.
7. The surviving spouse is generally entitled to withdraw principal from the B and C Trusts for the surviving spouse's health, education, support and maintenance (HESM), but cannot be frivolous with the principal of the B or C Trusts (example, cannot gamble or invest speculatively).

Now, time and time again when I review AB and ABC trusts with clients, I draw the above diagrams and recite the details stated above, and then I hear one or both of them make the following statements, and here is how I respond.

Statement 1: **My understanding is that my spouse will have *complete control* over *all* the trust assets after I die, *right*?**

My response: Yes . . . . . Almost! The difference is *control* vs. *right to spend on yourself*. The surviving spouse usually has complete *control* over the A, B, and C trusts by being appointed the sole successor trustee. This means that the survivor can dictate investment decisions and has control over the checkbooks. The survivor also has the right to spend the A trust income and principal without restriction, along with the income from the B and C trusts. However, the survivor only has the right to spend principal from the B and C trust to the extent needed for the survivor's health, education, support or maintenance. Any amounts of principal of the B and C trusts not needed for those specific purposes must stay in the B or C trust respectively. Hence my answer, Yes . . . . . Almost!

Statement 2: **My understanding is that my spouse has the right to make any *changes* that are desired after I die, *right*?**

My response: Yes . . . . . Almost! The survivor will have the power to change the A trust only. The B and C trusts are irrevocable and cannot be changed (beneficiaries and successor trustees are irrevocable).

Statement 3: **My understanding is that our beneficiaries don't have to be told how we set up our trust until we are both gone, *right*?**

My response: You guessed it. Yes . . . . . Almost! Yes for the A trust, but California law states that when a trust becomes irrevocable, the Trustee MUST notify the beneficiaries and the trustor's heirs at law of that fact, and must provide a copy of the trust to the beneficiaries or heirs upon request. At the death of the first spouse, the B and C trusts become irrevocable, triggering these notification requirements.

You probably see where this is going. I then tell them that each trust will have its own checkbook, files its own income tax return every year, and that the survivor will need to keep the assets in those separate trusts separate in their minds. There are also legal fees related to the administration of the trusts when the first spouse dies. There is generally less work to do, and therefore less legal fees, for an all to A trust administration, as compared to an AB or ABC trust split administration. So now there is a perceived lack of privacy, perceived loss of control and perceived increase of cost and complexity in administering their AB or ABC trust. Then they ask me why their attorney gave them an AB or ABC trust in the first place. It probably wasn't bad legal advice at the time. It mostly had to do with the smaller exemptions that existed before 2002. Since the 1980's, when the exemption was \$600,000, it was standard planning to draft an AB or ABC trust due to its estate tax reduction characteristics. However, since the exemptions have been significantly increased, *flexibility* has become the name of the game for those who trust their surviving spouse with the power to change everything.

With an AB Disclaimer trust, the surviving spouse has the option, but is not required, to sign specific papers within 9 months of the death of the first spouse, evidencing an election to fund the B trust, thereby at least partially utilizing the exemption of the first spouse to die ( $E_{DS}$ ). If the survivor does elect to fund the B trust, then all the requirements listed above that apply to the B trust apply to this B trust. If the survivor does not elect to fund the B trust within 9 months of the death of the first spouse, then the first spouse's exemption ( $E_{DS}$ ) will be lost forever, and the surviving spouse only has the survivor's own exemption ( $E_{SS}$ ) to cover the entire estate at the survivor's death, and any amount of the estate exceeding ( $E_{SS}$ ) will be subject to estate tax.

HOWEVER, don't forget the DSUE mentioned earlier. If the surviving spouse funds all the trust assets into the A trust only, AND if the surviving spouse files a timely federal estate return (IRS Form 706) for the deceased spouse's estate (no small task), then the deceased spouses exemption ( $E_{DS}$ ) is made available to the surviving spouse to use for lifetime gifting and/or to use at the surviving spouse's death. The result is that at the surviving spouse's death, only the estate value that exceeds the sum of ( $E_{SS}$ ) and ( $E_{DS}$ ) will be subject to federal estate tax (subject to lifetime gifting that may use up some of these exemptions during lifetime). The result is the benefit of preserving and using both exemptions, without the necessity of using those irrevocable B or C trusts.

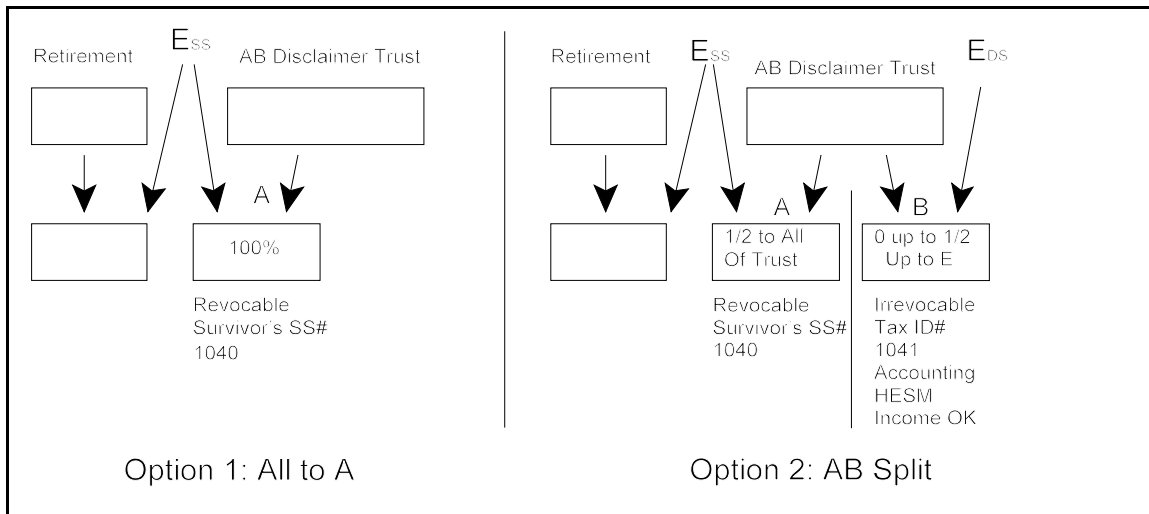


Figure 2: AB Disclaimer Trust Diagram (both options)

The moral of the story is that you need to evaluate the differences of these *AB type* trusts as if though *you are the surviving spouse*. What choices do *you* want to have? What level of complexity can *you* tolerate? If you don't want to be forced into having multiple trusts, and would rather have a *choice*, then you need an AB Disclaimer trust. However, in order change to an AB Disclaimer trust, **YOU MUST BE WILLING TO GIVE YOUR SPOUSE THE POWER TO CHANGE EVERYTHING AFTER YOU ARE GONE -- NOT THAT HE OR SHE WILL, BUT THAT HE OR SHE MUST HAVE THE POWER TO CHANGE EVERYTHING**. If this is not acceptable to you, then you probably still need your AB or ABC trust.

Flexibility has become the name of the game in estate planning. Virtually all of the trusts that I draft today for married clients are AB Disclaimer trusts due to today's higher exemptions, the DSUE, and clients' desires to keep things as simple as possible. Whether or not you amend and restate your AB or ABC trust to an AB Disclaimer trust, please read this flyer as many times as it takes for you to understand how your trust affects you *as a surviving spouse*. Don't wait until one of you has passed on, it will be too late to make the change. Feel fortunate to have read this flyer while you still have the power to change your trust, and if you do decide that an AB Disclaimer trust is best for you, call us now to make the change.

Should you wish to discuss in detail with this firm how the AB Disclaimer trust could benefit you, as well as planning options available to you, please call my office to schedule a consultation. These meetings are billed at our regular hourly rate (currently \$250/hr as of 4/24/14).

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