

AB Trusts to Save Tax and Wealth

Couples can save estate taxes with this kind of trust.

Many people don't need to think about federal estate tax, which kicks in only when someone dies owning a very large amount of property. The amount of the estate tax exemption depends on the year of death.

| Year | Estate tax exemption |
|---------|--|
| 2005 | \$1.5 million |
| 2006-08 | \$2 million |
| 2009 | \$3.5 million |
| 2010 | No estate tax |
| 2011 | \$1 million unless Congress extends repeal |

If you and your spouse expect that your estate may owe the tax, consider creating a living trust that will both avoid probate and also save on federal estate tax. If you don't, there may be a big estate tax bill when the second spouse dies. That's because the surviving spouse's estate will include his or her share of the couple's property plus the property inherited from the deceased spouse.

An AB trust, also known as a credit shelter trust, lets a couple pass the maximum amount of property to their children or other beneficiaries after both spouses die, while at the same time ensuring the surviving spouse is financially comfortable during his or her lifetime. In lieu of leaving property outright to the surviving spouse, each spouse leaves most or all of his or her property to an AB trust. When one spouse dies, the surviving spouse can use that property, with certain restrictions, but doesn't own it outright. That's the reason behind the big tax savings: The property isn't subject to estate tax when the second spouse dies, because the second spouse never legally owned it.

When developing an AB trust, each spouse names final beneficiaries who will receive the trust's property when the surviving spouse dies. Spouses often name the same people as their children as final beneficiaries. It is not mandatory.

EXAMPLE

Christine and Terry have a combined estate of \$3 million, all of which they own together. If each left his or her half, \$1.5 million, to the surviving spouse outright, that spouse would be left with an estate of \$3 million. If the surviving spouse died in 2006, \$1 million would be subject to estate tax.

But if Christine and Terry each leave their half of the trust property in an AB trust, naming their five children as the trust's final beneficiaries, no estate tax will be due. Let's say Christine dies in 2006. Her \$1.5 million goes into an irrevocable trust for Terry, and is subject to estate tax at that time. But because the amount in the irrevocable trust is less than the federal estate tax exemption, no tax is due. Similarly, when Terry dies later, his \$1.5 million is also less than the exempt amount.

The Surviving Spouse's Rights

The surviving spouse has limited power over the assets in the irrevocable trust. The extent of this power depends on the terms of the trust, within certain limits set by the IRS. If a surviving spouse is given more power than IRS rules allow, the surviving spouse becomes the legal owner of the trust property -- exactly what you don't want.

When the maximum powers are granted, the surviving spouse:

- receives all interest or other income from the trust property
- may use the property -- for example, he or she can live in a house held in trust
- may spend the trust property in any amount for his or her health, education, support and maintenance, in his or her accustomed manner of living. (IRS Reg. 20.2041-1(c)(2).)

In other words, the surviving spouse has the right to use all of the trust principal for what really concerns most older couples: the surviving spouse's health care and other basic needs.

After the death of the surviving spouse, the irrevocable trust property is distributed to the final beneficiaries, chosen by the deceased spouse in the original trust document. The surviving spouse's property is also distributed to her beneficiaries.

Drawbacks of an AB Trust

Before creating an AB trust, couples should understand what they're getting into. Once one spouse dies, the trust cannot be changed.

Possible drawbacks include:

- **Restrictions on the surviving spouse's use of the property.** As discussed above, the surviving spouse has only limited rights to use trust property in the irrevocable trust.
- **Expense of legal or accounting help.** When one spouse dies, the survivor will need to hire a lawyer or accountant to determine how to best divide the couple's assets between the irrevocable trust and the surviving spouse's revocable living trust. How the property is divided can have important tax consequences.

- **Trust tax returns.** The surviving spouse must get a taxpayer ID number for the irrevocable trust and file an annual trust income tax return. Like any tax return, this requires some work.
- **Recordkeeping.** The surviving spouse must keep separate records for the irrevocable trust property.
- **Uncertainty about the tax laws.** Because Congress is almost sure to tinker with estate tax laws again in the next few years, you may end up wanting to change or revoke a trust you create now.

Given these disadvantages, it's obvious that not all married couples with a combined estate over the estate tax threshold should use an AB trust. It's generally not advisable, at least not without the advice of an experienced estate planning lawyer, for many couples under 60. People in this age group don't want assets to be tied up in a trust if one spouse dies unexpectedly.

Commonly, younger couples create a basic probate-avoidance living trust. When they're older, they revoke it and create an AB trust. And if one spouse unexpectedly dies sooner, the survivor will inherit everything free of estate tax, no matter what the amount. The surviving spouse will probably have years to use the money -- and to find other methods of reducing eventual estate tax.

Other couples who may not need an AB trust include:

- **Couples where one spouse is considerably younger than the other.** There's generally no need to burden the second spouse with a trust designed to save estate taxes when he or she is likely to live for many years.
- **Many couples with children from prior marriages.** There may be concern about conflicts between the surviving spouse and the deceased spouse's children, who must essentially share ownership of property for many years.

Family Conflicts

With an AB trust, there is an inherent possibility of conflict of interest between the surviving spouse and the final beneficiaries. The final beneficiaries may want all the trust property conserved, no matter what the needs of the surviving spouse. But the surviving spouse may want to spend trust principal.

An AB trust works best when the final beneficiaries understand that taking the trouble to create the trust is a generous act by parents. After all, the parents do not benefit themselves, but their inheritors receive much more of the couple's combined estate than they would if the spouses simply left property to each other. The final beneficiaries should also understand that all property in the trust should be available for the surviving spouse.

Despite its possible drawbacks, an AB trust does work very well for many families. Many older couples conclude that the relatively minor accounting and recordkeeping hassles are outweighed by the benefits.