# Trust in Pieces: Formulas and Funding

**Southern Arizona Estate Planning Council**

**June 28, 2025**

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# Section I – Estate planning and drafting using formula clauses

Drafting with formula clauses in trusts

a. What is a formula clause?
b. When do you need a formula clause?

Joint Trust Options for Married Couple

1. No Split at first death, all "A"/Survivor's Trust
2. Optional split at first death, A/Survivor's Trust, with an optional disclaimer B/Credit Shelter Trust
3. Two Trust split at first death, A (with Marital deduction if necessary)
4. Three Trust split at first death, A(Survivor's), B(Credit Shelter), Q (Marital Deduction amount/QTIP) if needed

1. Purposes for Splits
   a. Estate tax planning
   b. Generation Skipping Tax Exemption
   c. Protecting Assets from surviving spouse making changes
   d. Asset protection for survivor

2. Downside of Splits
   a. Annual Tax Return
   b. Lack of step-up in conventionally drafted B Trusts

3. Variables for Irrevocable Split Trusts B's or Q's
   a. All income or not?
   b. Flexibility of B Trust that qualifies for QTIP and step-up at survivor's death
   c. Discretionary principal terms, do they have to use A first?
   d. Do they have a power of appointment? Is it broad and limited enough? Tax formula

4. The typical mechanics for an “A-B” Trust, especially in Arizona and absent significant separate assets, would be for husband and wife to create a joint trust, and upon the death of the first spouse, the Trust divides into a revocable Survivor’s Trust (“A”) and an irrevocable Family/Credit Shelter/Decedent’s/Bypass Trust (“B”). The Irrevocable Bypass Trust B used the deceased spouse’s estate tax exemption so that it would not be subject to any estate tax when the survivor dies. Experienced practitioners have dealt with the fallout from these arrangements for many years, and are aware that many times the issue is not whether there is an A-B Trust, but rather the specific terms and details of

the Irrevocable Family/Decedent's/Bypass Trust B are under the document. Does the survivor have too much/too little control and flexibility over the arrangement?

5. The Devil's in the Details: What Does the Bypass Trust B Say
    a. The technical requirements for the Bypass Trust B to work, in classical estate tax planning, are minimal. Because the assets are deemed transferred from another person, the deceased spouse, the only estate tax rule the Bypass Trust must avoid is the General Power of Appointment limitation under § 2041 of the Code. To avoid estate tax inclusion under § 2041, the survivor cannot have a power to distribute property to himself or herself unless it is based upon an ascertainable standard. So, if the survivor is his or her own Trustee, any discretionary distributions must be for health, support, maintenance, and/or education (commonly called the "HEMS" Standard). Practitioners who try to please a client or be more creative can run afoul of this rule by adding standards such as Happiness, Welfare, or Best Interests. **DON'T DO THIS!** There is probably not much substantive difference between those concepts, but the technical interpretation from a tax perspective is a killer. The other rule is that upon death (or, at life, if a power of appointment is granted then), the survivor cannot be able to appoint to himself or herself, his or her estate, his or her creditors, or the creditors of his or her estate. As long as the Bypass Trust is irrevocable, and it does not run afoul of these rules, it should not be subject to estate tax at the survivor's death. Additionally, it should also have the legal protection from creditors discussed in more detail below.

    b. Because of this, it is the details of the Bypass Trust that determine it's non-tax substance. A loosely drafted Bypass Trust can be nothing more than a technically irrevocable trust from which the Survivor can practically do absolutely anything he or she wants with the money. Or, it could be so rigidly drafted that the survivor gets almost no benefit at all, and/or has substantial legal obligations to other beneficiaries. These details mean far more to the substance of the Trust then whether there IS a Bypass Trust. The terms of this trust are always a Goldilocks situation of trying to find a porridge that is not too hot, nor too cold, but just right, except that in this situation the "just right" is what the person setting up the trust wants it to be.

        i. **<u>Broadly Drafted Bypass Trust:</u>** For example, the Trust could let the surviving spouse be his or her own Trustee, with a right to all the income, and a right to distribute principal in the Trustee's discretion for the survivor's health, maintenance and support, without considering any other resources or assets of the survivor. The survivor can have a power to appoint at his or her death in favor of any individual or charity in the whole world, only excluding the survivor's estate and creditors.

1. Not only does the survivor as Trustee directly have the power to do pretty much anything he or she wants in spending the money, but the ability to exercise the power and change the beneficiaries also cuts off anyone from being able to complain about it. For instance, if the remainder beneficiaries are the deceased spouse's separate children, and they start to complain about how the survivor as Trustee is investing or spending the money; the survivor can exercise the power and completely cut those beneficiaries out, including their legal standing to argue about the current administration.

    a. Such an arrangement may be "just right" if both spouses want the survivor to have unfettered power, and only want the Trust for the tax benefits and/or creditor protection.

ii. **Strictly Drafted Bypass Trust:** By contrast, on the other side of the spectrum, the Bypass Trust could be drafted with a professional Trustee, or perhaps even worse for the survivor, the remainder beneficiaries, as the Trustee. It could provide the survivor would only get income or principal if the Trustee deems it appropriate in emergency situations, and only if the survivor has no other assets. The survivor may have NO power to appoint whatsoever. In such a trust, the survivor would have no real control and very little practical benefits. Absolutely the other side of the spectrum from the prior example.

iii. Obviously, there is a lot of middle ground between these two extremes, and here are the details that can be adjusted:

1. Who is the Trustee? If the survivor is their own Trustee, they will have much more control.

2. What are the distribution standards? Even assuming it is a HEMS standard, it can vary greatly if no principal can be invaded as long as the survivor has other assets. It can also vary greatly if it allows other beneficiaries to receive distributions during the survivor's lifetime.

3. Is there a Power of Appointment? An appropriate amount of flexibility in this arrangement is vital. We have all seen this

drafted in a manner that did not appear appropriate after the first spouse dies - whether it is something so broad it allows the survivor to disinherit the deceased spouse's family completely, or so limited that a surviving spouse who was married to the decedent for 60 years has no ability to adjust the format of distribution for his or her own children, including such benefits as Lifetime Protection Trusts or Special Needs Trusts. For many clients, a happy medium is a power limited to the couple's children and their descendants, but with the ability to adjust shares and trust formats among those beneficiaries.

c. There are many parts of trust agreements which are, for lack of a better word, fairly boilerplate in terms of administrative provisions that make sense to be included no matter what. **The substantive details of the Bypass Trust are critical for clients to understand.** Too many times the provisions controlling these details seem to be part of the trust form may not have been discussed with detail for the clients.

6. Community Property Funding: The Large IRA Conundrum Solved . . . Non Tax Issues Remain

a. Especially in our recent past of lower estate tax exemptions, a married couple who had enough assets to incur an estate tax without an A-B Trust arrangement - but where a bulk of their assets were in qualified retirement plans - created a planning problem. Trying to name anyone but the surviving spouse as the primary of the beneficiary of the retirement plans, especially a trust, was problematic on every level. Problems ranged from the complexity of the income tax rates to minimum distribution rules. However, by not adequately funding the Bypass Trust increased the chance of estate taxes that could have been avoided or minimized.

b. For instance, back when we had a $600,000 exemption, imagine a couple had $600,000 in wife's IRA, $600,000 in the couple's brokerage account, and no other assets. Even if the husband and wife established a typical joint revocable trust which divides between a Survivor's Trust and a Bypass Trust to save estate taxes upon the survivor's death, this situation created a major concern with estate taxes. At the first death, if we kept the survivor the benficiary of the IRA, which makes the most sense, the most that could normally be allocated to the Bypass Trust would be 1/2 of the other assets, or $300,000. Meaning they left $300,000 of their exemption on the table (in the pre-portability world) and if the survivor died with more than their exemption (in the old $600K exemption world) then they would have had to pay estate tax, which could have avoided if they had been able to fully fund the Bypass Trust.

c. Arizona's community property laws, now strengthened by specific statutes that authorize this arrangement, provided a beautiful and simple solution. Utilizing community property funding theory, a Trust Agreement can provide that no matter who dies first, the Trustee takes into account the community property interest passing directly to the surviving spouse, and treats that as a share of the Survivor's Trust. In the above example, whether or not the husband or wife died first, the Trustee would consider that the entire community is worth $1,200,000, and that the $600,000 in the IRA passing directly to the surviving spouse should be charged against the share of the Survivor's Trust. Thus the entire remaining $600,000 is allocated to the Bypass Trust. The Bypass Trust is thus fully funded, and the only assets included in the survivor's estate is the IRA, which is equal to the estate tax exemption and no estate tax is incurred!

d. There was an elegant, beautiful, and powerful solution to the above described situation. It avoids having to do anything complicated to the IRA, and it leaves maximum flexibility as far as payouts.

e. Arizona is an "aggregate" community property state, and this designation works as specified under a Trust even before we added specific trust and probate assets to deal with it.
    i. Under A.R.S. § 25-211, "[A]ll property acquired by either husband or wife during the marriage is the community property of the husband and wife. except for assets acquired by gift, devise, or descent, or after petition for dissolution of marriage, legal separation, or annulment."
    ii. Pursuant to A.R.S. §25-318, Arizona's community property theory is an aggregate theory rather than an item basis, in that each spouse is entitled upon divorce to an equal share of the aggregate community property, but not an in-kind, half interest in every community property asset. For example, if the husband and wife's community property consisted of a $300,000 home and a $300,000 brokerage account, the court could assign the husband the home and the wife the account as an equitable division of their community property assets.
    iii. Case law also has distinguished the importance of this designation:
        1. Where community and separate assets are commingled to the extent that segregation is impracticable, the assets are considered to be community property. Evans v. Evans, 79 Ariz. 284, 288 P.2d 775 (1955).
        2. All property acquired after marriage is presumed to be

community property. Horton v. Horton, 35 Ariz. 378, 278 P. 370 (1929);
Rundle v. Winters, 38 Ariz. 239, 298 P. 929 (1931).

f. If the trust needs to account for the community property division, here is a sample of such Trust language:

   i. Notwithstanding the funding provisions of . . ., for purposes of funding the Survivor's Trust, any community property interest which the Surviving Settlor and the Deceased Settlor have at the Deceased Settlor's death in any Individual Retirement Account ("Account") or Qualified Retirement Plan ("Plan") which passes to the Surviving Settlor pursuant to the terms of said Account or Plan, the applicable beneficiary designations then in effect, and applicable state law, whether the Deceased Settlor or the Surviving Settlor is the owner or participant of such Account or Plan, shall be considered the community property of the Settlors for funding purposes of this Agreement, and shall be deemed for such funding purposes to be allocated to the Survivor's Trust, since the Surviving Settlor has control and ownership of said Account or Plan, as part or all of the Surviving Settlor's share of the community property of the Settlors provided for under [Relevant provisions]. If the total community property in such Accounts or Plans exceeds the Surviving Settlor's share of the community property, no amount shall be allocated to the Survivor's Trust under [Relevant provisions] but the Deceased Spouse's remaining share of the community property shall be allocated pursuant to the [Relevant Provisions].

g. Arizona's Title 14 has been specifically amended over the past few years to specifically authorize this type of allocation with respect to community property, in both a probate estate and in trust division:

## 14-10816:

Without limiting the authority conferred by section 14-10815, a trustee may:

. . . .

22. On distribution of trust property or the division or termination of a trust, make distributions in divided or undivided interests, allocate particular assets, including community property, in proportionate or disproportionate shares, value the trust property for those purposes and adjust for resulting differences in valuation. In making a division or distribution of community

property held in trust, the trustee may consider community property held outside the trust so that the division of community property held in the trust and outside of the trust is made based on equal value but not necessarily proportionately.

## 14-3916. Community property:

In making a division or distribution of community property held in the decedent's estate, the personal representative may consider community property held outside the estate so that the division of community property held in the estate and outside the estate is based on equal value but is not necessarily proportionate.

Note that in both statutes the allocation is permissive, not required.

h. See also *In re Estate of Kirkes*, 231 Ariz. 334 (2013), where the Supreme Court of Arizona ruled that the surviving spouse was not entitled to 50% of a retirement account, so long as the spouse receives in the aggregate 50% of the entire community.

i. **So…Why are you Telling us this?** The overall changes in the estate tax law have impacted the importance of this issue. Portability alone theoretically avoids the need for this planning allocation regardless of the estate size, and when factored into the much greater estate tax exemption, it is still less likely to be an issue. However, the non-tax issues involved in this issue remain equally important. Where the Bypass Trust is relatively restrictive, whether or not the retirement plans must or may be taken into account when funding the Bypass Trust, is **STILL** going to significantly shift the rights of the individuals involved. For instance, consider the situation where a married couple with significant retirement accounts each want an A-B split and benefit their own separate set of specific beneficiaries. Without a ***MANDATORY*** allocation based on the retirement plans, the deceased spouse's irrevocable trust funds, and the amount available for ultimate beneficiaries of that trust, would be much less, and it would important for the clients to look at the results and choose how they wanted the plan set up. Without estate taxes being an issue, everything comes down to understanding the results and choosing what arrangement works best. With the Arizona statutes as the only provision to rely upon, the permissive nature gives a great deal of power to shift benefits in the hands of the Trustee or the Personal Representative.

I. The Disclaimer Option

A. A tool that became increasingly popular over the last few years of uncertainty is the “Disclaimer Trust,” a more flexible compromise between the Bypass Trust B and outright distribution. Like many techniques, there are pros and cons.

B. The basics of this type of Trust would say, “When the first spouse dies, the decedent’s share of all the trust assets are held in a continuing revocable trust for the survivor to do anything he or she wishes. HOWEVER, if the survivor elects to disclaim any of the decedent’s share, it will then be held in Trust B/Family Trust/Credit Shelter/Bypass Trust for the survivor instead.”

1. Therefore, when the first spouse dies, he or she can decide whether to take on the administration work of funding the Disclaimer Trust, based on whether it seems likely it will save future estate taxes. If the survivor decides it is not worth doing, nothing needs to be done. If the survivor decides it is worth it, he or she can set it up and they fund the Trust B/Family Trust/Credit Shelter/Bypass Trust under the terms of the document.

C. However, the cons to this particular arrangement are as follows:

1. At the time of the first spouse’s death, there is still uncertainty. While it is possible that the survivor can have is a much clearer picture of life expectancy, estate tax law, and assets when the first spouse dies, the survivor really does not know the future, and it is not until the survivor dies that we really know whether the Trust B/Family Trust/Credit Shelter/Bypass Trust will save any money. So, to some extent, there truly may not be a great deal more knowledge at the first death than at the time the documents were drafted.

2. The disclaimer, under the technical requirements of the Internal Revenue Code, must be made properly within nine (9) months of the deceased spouse’s date of death. While not an unreasonable deadline, it remains too easy for the time to lapse and then it is too late. This is in interesting contrast to a mandatory A-B division, because while there is no absolute deadline for the A-B division to take place - despite not being great planning - the division can be done, if necessary, years after the fact.

3. ***Most importantly, the technical requirements for the disclaimer prohibit the survivor from having a power of appointment over the***

***trust.*** This can be a critical tool to give adequate flexibility to the Bypass Trust. So, while there is the deadline of 9 months after death; after that time, if the Bypass Trust is created through disclaimer, the survivor has no more flexibility to change the ultimate disposition of the Bypass Trust. Ultimately, that flexibility may be quite important.

D. If a Disclaimer Trust is ultimately chosen by the client, the client may consider adding a Trust Protector, a trustworthy independent party who could make minor changes among the beneficiaries. This will not give the survivor the direct power, but it can be much better than nothing, and provides a mechanism for changing the trust if circumstances change - basically the type of changes that we would want the survivor to otherwise have the power to make under a power of appointment.

E. In addition, consider that if any part of the Bypass Trust non-tax purpose is to limit what the survivor can do - the fact it is left wholly optional means that they really are not bound at all. If, on the other hand, the whole idea is to let the survivor do whatever he or she wishes with the assets, and the only purpose of the Bypass Trust is the estate tax savings or creditor protection, the lack of the ability to include a Limited Power of Appointment really means the survivor must deal with the full realities of an irrevocable trust and this may not be a good fit.

II. What Happens to any Excess Funds? Funding formulas and the Marital/QTIP

A. The funding of a Bypass Trust, up to the amount of the available estate tax exemption, is pretty simple. The Bypass Trust will receive a share of the assets equal to the decedent's assets. If there is separate property, it will include all of the decedent's separate property and none of the survivor's separate property. Since separate property is discrete, it is not a question of amounts or value, those assets are simply funded. If there is community property, the Bypass Trust will also receive one-half of the total community property, representing the decedent's share thereof. Note the discussion above that the assets can be allocated with any of the community property assets so long as the value of the assets chosen is equal to one-half of the community assets. This is akin to the fractional formula funding discussed below, and as such, no income tax is realized from this funding. *Also be aware, all the community property receives a new cost basis for income tax purposes based upon the value at the deceased spouses death.*

B. In the event that the value of the Decedent's property exceeds the available estate tax exemption for him or her, a trust will generally make provision to avoid any estate tax at that time through the application of the marital deduction. In a Trust Agreement this arrangement only provides for the “two-trust” split, between the Survivor’s Trust (or Trust A) and a Credit Shelter Trust (aka Trust B, Decedent’s Trust, Bypass Trust). Thus, all of the survivor’s property (½ of all community property, and all of the survivor’s separate property) is allocated to the Survivor’s Trust. The deceased spouse’s property is used to fund the Credit Shelter Trust, up to the estate tax exemption amount applicable for the deceased spouse’s year of death. If the deceased spouse’s property is in excess of the estate tax exemption, the excess is added to the Survivor’s Trust to qualify for a marital deduction.

C. **Three Trust Split/ABQ/ABC/Marital Trust/QTIP Trust:** This option, which has decreased in prevalence as the exemptions have gone up, creates a third Irrevocable Trust to deal with the excess of the decedent’s property. Upon the first death, a division is made between a Survivor’s Trust, Bypass Trust, and a Marital Trust (“QTIP Trust”). Under this arrangement, all of the survivor’s property (½ of all community property and all of the survivor’s separate property) is allocated to the Survivor’s Trust. The deceased spouse’s property is used to fund the Bypass Trust, up to the estate tax exemption amount applicable for the deceased spouse’s year of death. If the deceased spouse’s property is in excess of the estate tax exemption, the excess is then used to create a third trust, the Marital Trust, which will qualify for the marital deduction if properly drafted, ensuring no estate tax will be paid upon the first spouse’s death. The Marital Trust, unlike the Bypass Trust, will be taxed upon the survivor’s death. The Marital Trust is designed so that upon the first spouse’s death, his or her Trustee or Personal Representative can make a “QTIP” election on the estate tax return, which allows the trust to qualify for the marital deduction.

D. A three trust split is appropriate when the clients want to make sure the deceased spouse’s property is irrevocable, protected from the survivor doing whatever he or she wants with it. This may be especially true when the Settlors have different beneficiaries, such as children from prior marriages.

E. **KEEP IN MIND THAT IF THE DECEDENT'S SHARE OF ASSETS IS UNDER THE AVAILABLE ESTATE TAX EXEMPTION, THEN THIS IS IRRELEVANT AND NO MARITAL TRUST WILL BE CREATED, EVEN IF THE DOCUMENT PROVIDES FOR IT. IN THOSE FACTS, THERE WILL BE NO DIFFERENCE BETWEEN A TWO-TRUST SPLIT OR A THREE-TRUST SPLIT.**

F. There are three basic funding formulas to determine the share to the Marital Trust (and these would also apply to the situation where there is an excess but it simply gets allocated to the Survivor’s Trust). Usually, these funding formulas will use the values at date of division in determining the split. **Keep**

**in mind, the only reason there are these complexities for funding is to deal with increase or decrease in values between date of death and funding. If all the assets remained of absolutely equal value, there would be no mathematical difference between any of the funding methods.**

G. "Pecuniary Marital" - The Trustee uses a fixed dollar amount, as determined on the estate tax return, for the value of the Marital Trust. At the time of funding, the Trustee distributes assets with a Date of Distribution value equal to this precise pecuniary amount into the Marital Trust and the balance goes into the Bypass Trust.

1. Sample language: *The trustee as of the death of the deceased Settlor shall set aside out of the trust estate, including any property added thereto by the will of the deceased Settlor, as a separate trust for the benefit of the surviving Settlor (undiminished to the extent possible by any estate or inheritance taxes or other charges) the smallest pecuniary amount which, if allowed as a federal estate tax marital deduction, would result in the least possible federal estate tax payable by reason of the death of the deceased Settlor.*

2. Under a Pecuniary Marital Formula, all appreciation (or depreciation) is allocated to the Bypass Trust. This is advantageous in with a trust estate that grows in size.

3. It is relatively easy to fund.

4. However, funding the Pecuniary Marital Formula is a taxable event, which will trigger recognition on any Income in Respect of a Decedent, or on any gain since date of death, for any assets passing to the Marital Trust.

H. "Pecuniary Bypass Trust" - This is the reverse of the Pecuniary Marital formula. The Trustee uses a fixed dollar amount, as determined on the estate tax return, for the value of the Bypass Trust ($5,450,000 for someone dying in 2016). At the time of funding, the Trustee distributes assets with a Date of Distribution value equal to this precise pecuniary amount into the Bypass Trust and the balance goes into the Marital Trust.

1. Sample language: *The trustee as of the death of the deceased Settlor shall set aside out of the trust estate, as a separate trust, the largest pecuniary amount which will not result in or increase federal estate tax payable by reason of the death of the deceased Settlor. In*

*determining the pecuniary amount the trustee shall consider the credit for state death taxes only to the extent those taxes are not thereby incurred or increased, shall assume that none of this trust qualifies for a federal estate tax deduction, and shall assume that all of the Marital Trust hereinafter established qualifies for the federal estate tax marital deduction. The Settlors recognize that the pecuniary amount may be reduced by certain state death taxes and administration expenses which are not deducted for federal estate tax purposes.*

2. Under a Pecuniary Bypass Formula, all appreciation (or depreciation) is allocated to the Marital Trust. This is advantageous with a trust estate that diminishes after the date of death.

3. It is relatively easy to fund, but is the least utilized of the three formulas.

4. Funding the Pecuniary Bypass Formula is a taxable event, which will trigger recognition on any Income in Respect of a Decedent, or on any gain since date of death, for any assets passing to the Bypass Trust.

I. "Fractional Funding" - A fraction, or percentage, for the Marital and Bypass Trusts is determined using the date of death values, and is used at the time of division to allocate the same exact fraction.

1. Sample language: *The trustee as of the death of the deceased Settlor shall set aside out of the trust estate as a separate trust for the benefit of the surviving Settlor (undiminished to the extent possible by any estate or inheritance taxes or other charges) a fraction of the trust property of which (I) the numerator is the smallest amount which, if allowed as a federal estate tax marital deduction, would result in the least possible federal estate tax payable by reason of the death of the deceased Settlor, and (ii) the denominator is the federal estate tax value of the assets included in the deceased Settlor's gross estate which became (or the proceeds, investments or reinvestments of which became) trust property.*

2. The fractional funding is the most complex of the three to fund. However, in practice the complexity seems to be greatly over stated and really is not harder to administer.

3. Neither trust changes relative to each other, regardless whether or not the trust estate appreciates or depreciates.

4. There is no taxable recognition at funding like there is with the Pecuniary Marital or Pecuniary Bypass. That makes this formula clause almost mandatory when Income in Respect of a Decedent Assets such as IRAs or deferred annuities may be payable to the trust. **It is the formula this author and most practitioners use most regularly, as it is essentially the "safest" provision.**

III. To B or not To B: The Non-Tax Issues

A. Let's go back to the big picture of whether or not an A-B Trust arrangement makes sense for a married couple setting up a trust.

B. The most prominent non-tax reason for a Bypass Trust gets back to the original goal of a trust, in general, to benefit someone without giving them full ownership. This allows a married couple to know that the survivor will have access to the assets in the Bypass Trust for his or her lifetime benefit, but that what remains upon his or her death will pass to the decedent's children, or other chosen beneficiaries. As with any trust, it helps deal with the uncertainty of circumstances. If the survivor lives for 30 years, they can use and extinguish the trust for their needs. If, however, they only survive 1 year, they cannot simply leave all the assets to a new spouse.

C. The details of the Bypass Trust will determine how much flexibility there is, and note that in the extreme (for instance, where the survivor has a limited power of appointment which can effectively benefit anyone in the world) there may be no real limits as to what the survivor can do with the assets.

D. There is no right or wrong on this issue, but something a married couple must decide as to their wishes in a joint document, or a client must decide for himself or herself what happens for their surviving spouse if they are creating a separate trust.

E. Classic examples would be a second marriage where each spouse has separate assets. The surviving spouse would be able to benefit himself or herself, but when he or she dies, the remaining Bypass Trust assets will pass to the deceased spouse's children. Keep in mind all of these situations are rough justice, and not perfect, but at least provide some additional protection in the big picture.

F. Even some happily married and trusting couples, with the same children or other beneficiaries, feel more comfortable with the legal limitations of a Bypass Trust. For example, they might say they trust each other completely, but if one of them lives to 102, they could be worried that survivor will become diminished and will become remarried, and they like the idea that the Bypass Trust is much more protected in those situations.

G. The other side of this is the survivor will have other beneficiaries in the trust with current legal rights, depending on the details, who can require an accounting of the trust, and, in the most extreme situation, could drag the survivor into court as to how he or she is administering the trust. This can become a momentous problem for families. Even without that, you have the additional formalities to deal with, such as separate titling, and the requirement of a separate (albeit simple) income tax return that is required each year. Widows who have survived their husband by 20 years in reality get quite weary with each year filing an income tax return every year for a $300,000 Bypass Trust.

H. It should also be noted that a Bypass Trust is also a fully protected spendthrift trust under Arizona law, and even where couples do not wish to substantively restrict each other each other at all, they might like the idea of the technical Bypass arrangement so that those assets will not be available if the survivor is sued. This can be "supercharged" when combined with large retirement accounts and community property funding. For example, a married couple (both surgeons) has $3,000,000 in non-IRA assets, and another $3,000,000 in IRAs, and they use an A-B Trust with community property funding. When the first spouse dies, there will be $3,000,000 in an IRA held directly by the survivor and $3,000,000 in the Bypass Trust. The Bypass Trust is a legally protected spendthrift trust from creditors. The IRA is generally protected from lawsuits under Arizona law. Suddenly, the surviving Surgeon has $6M in total assets under his or her direct control, none of which technically can be touched in a lawsuit!

IV. To B or not To B: The Tax Issues

A. Generally there are potential estate tax benefits to the Bypass Trust in large estates, including the results from being able to maximize Generation Skipping exempt trusts. While there are uncertain, there is **generally no ESTATE tax downside to the Bypass Trust**.

1. For clients with enough money to exceed the exemption amount, the A-B Trust is a more tax-effective strategy than relying upon the portability provision. One concern is that the portability law could be

discontinued. Even if it remains, having separate trusts allows the surviving spouse more flexibility and control. With separate trusts, the survivor can spend the money from Trust A and let Trust B grow and appreciate, gradually ensuring that more and more money is not subject to estate tax.

**EXAMPLE 1:** So, for a simple example, let us use $14 million as the approximate estate tax exemption, and let us say a married couple have $30 million when the first spouse dies. If the couple relies on portability, and leaves everything outright to the surviving spouse upon the first spouse's death and they file an estate tax return, the survivor is able to "carry forward" under portability the deceased spouse's $14 million in unused estate tax exemption. (The technical term of "Deceased Spouse's Unused Estate Amount", abbreviated DSUEA and pronounced "Dis-Ooh-Eee-Yay" can be used if you want to fit in with the hippest of estate planners!)

Let us assume the assets appreciate to $38 million when the survivor dies. The survivor has a $19 million estate. They have their own $14 million exemption, and they have their deceased spouse's carry-forward-exemption aka DSUEA of $14 million. Therefore the combined exemptions cover $28 million and the excess, $10 million, is taxed at about 40%, and the estate owes $4,000,000.

## CALCULATION:

At first death: $30,000,0000
No division

At second death: $38,000,000

Taxable Estate: $38,000,000

Survivor's Exemption $14,000,000

Carry forward DSUEA $14,000,000

Amount Subject to Estate Tax: $10,000,000

Estate Tax: $4,000,000

***EXAMPLE 2:*** Instead, if the spouses set up an A-B Trust, upon the first spouse's death, the $30,000,000 is divided up between a $16,000,000 Survivor's Trust A and a $14,000,000 Bypass/Bypass Trust B.

Even if the survivor invests and spends identically from the two trusts, when survivor dies, the survivor's trust will be about $20,300,000 when the survivor dies, and the Bypass Trust B will be about $17,700,000.

## CALCULATION:

| | |
|---|---|
| At first death: | $30,000,000 |
| Division: | |
| Survivor's Trust | $16,000,000 |
| Bypass Trust B | $14,000,000 |
| | |
| At second death: | $38,000,000 |
| Survivor's Trust | $20,300,000 |
| Bypass Trust B | $17,700,000 |
| | |
| Taxable Estate: | $20,300,000 |
| | |
| Survivor's Exemption | -$14,000,000 |

| | |
|---|---|
| Amount subject to estate tax | $6,300,000 |
| Approximate estate tax | $2,500,000 |

So even in a situation where the trusts are treated exactly the same, you still save $1,500,000 estate tax!

***EXAMPLE 3:*** Same as example 2, except the survivor acts strategically to spend the money from the Survivor's Trust as much as possible and grow the money in the Bypass Trust. So, when the survivor dies, there is only $17,000,000 in the Survivor's Trust and $21,000,000 in the Bypass Trust.

# CALCULATION:

| | |
|---|---|
| At first death: | $30,000,000 |
| Division: | |
| Survivor's Trust | $16,000,000 |
| Bypass Trust B | $14,000,000 |
| | |
| At second death: | $38,000,000 |
| Survivor's Trust | $17,000,000 |
| Bypass Trust | $21,000,000 |
| | |
| Taxable Estate | $17,000,000 |
| Survivor's Exemption | $14,000,000 |
| | |
| Amount Subject to Estate Tax | $3,000,000 |
| Approximate Estate Tax | $1,200,000 |

Now you have saved $2.8 million over relying upon portability!

Additionally, the generation-skipping tax (GST) exemption of the first spouse is not preserved through portability. It is, however, preserved in an Irrevocable Bypass Trust, and that results in more estate tax savings for the *next* generation.

Even those clients who do not currently have enough assets to warrant estate tax concerns now may be concerned that Congress may lower the exemptions at some point.

B. Income Taxes: The Downside of the Bypass Trust

1. While the Bypass Trust may reduce estate taxes for clients over the $14M estate tax exemption mark, especially for clients with more than the $28M double-threshold, it has certain income tax downside. While there used to be a wider divide between income taxes and estate taxes which made this trade-off beneficial, income taxes are on the rise, the estate tax top rate is permanently lower, and many

clients may not owe estate tax no matter what, especially with portability, so these income tax detriments may be a problem that eclipses any potential estate tax savings.

2. One issue is that an irrevocable Bypass Trust is subject to the punitive compression of tax brackets for income held within the trust, and in the same idea, is subject to many of the increased taxes due to the ACA which only cut in for individual taxpayers at much higher rates. Of great concern is a Trust which may not be able to deduct certain accounting principal as Distributable Net Income ("DNI") by distributing it out to the beneficiary, and therefore trap the income in the trust at the higher rates and kick in things like the net investment income tax. For a Bypass Trust or any other Irrevocable Trust, it is beneficial to have a tool available within the Trustee's powers to make appropriate adjustments, such as the following:

   *To allocate capital gains to trust income instead of corpus or principal for purposes of Section 643(a)(3) and (b) of the Code, if, and to the extent, the Trustee shall determine appropriate in its sole discretion*

   Keep in mind to be careful in situations where the determination of income could drastically alter the rights of people involved.

   The even more direct issue for most clients is the lack of the step-up in cost basis upon death that applies for income tax purposes when assets are included in your estate. That adjustment is based upon estate tax inclusion (even for estates well below the tax threshold) so the same rules that apply to determine if assets are taxed in your estate are what determines (in reverse, essentially) whether you get the step-up in cost basis. **So, your properly drafted Bypass Trust which works for estate tax purposes will specifically NOT receive the step up in cost basis.**

3. In a situation where there will be no estate tax paid with portability, then from a pure income tax perspective, there can be a great disadvantage to the Bypass Trust.

   EXAMPLE 1: Assume Wife dies when H&W's community property is worth $4,000,000 - all community property, which becomes the cost basis. Now let's assume that during Husband's lifetime, those assets appreciate to $8,000,000. At Husband's death, let's also pretend the children beneficiaries are desperate for money and immediately sell all the assets in the estate to go purchase their fleets of luxuries vehicles and swimming pools.

IF: The couple did a Bypass Trust (we will assume they appreciated proportionately), that started as a $2M Survivor's Trust and a $2M Bypass Trust, then upon the survivor's death, there would be a $4M Survivor's Trust and a $4M Bypass Trust. At the survivor's death, the $4M Survivor's Trust is included in their estate and gets a new cost basis so when the children sell it, there is $0 capital gains. However, the Bypass Trust did not get a step-up, and assuming the assets retain their original basis, there will be capital gains based on the value of the Husband's death ($4M, determined when it is sold), reduced by the basis, which was the value as of the Wife's death ($2M). Therefore, there is a tax on $2M of capital gain.

What if instead, the couple did not create a Bypass Trust and Husband owned all the assets at his death; then, portability, if still in effect, would work to avoid any estate tax as well. However, all the assets would have a new cost basis and when the children sell the $8M there would be NO capital gain.

4. After recognizing that reality there are some options to consider to allow you to get that step-up in cost basis upon the survivor's death in certain circumstances. My approach is to include in the document provisions for a very limited Trust Protector who can grant the survivor a general power of appointment, which, consistent with the estate tax laws, will include the assets in the survivor's estate and get the cost basis. Here is an example of that sample language:

   a. During the lifetime of the Surviving Spouse, a majority of the adult Qualified Beneficiaries as defined under Arizona law (excluding the Surviving Spouse) may from time to time appoint (and remove and replace) an "Inclusion Trust Protector" with respect to the Family Trust, with a signed writing delivered to the Trustee. The Inclusion Trust Protector must be [**Consider qualifications]**

   b. The Inclusion Trust Protector's sole power shall be to amend the scope of the Surviving Spouse's Power to Appoint the Family Trust. The power to amend the scope of that Power of Appointment shall be to add, as a permissible appointee, the creditors of the Surviving Spouse's estate, or, if they have already been added as a permissible appointee, to remove and delete the creditors of the Surviving Spouse's estate as a permissible appointee. The purpose of such power is to give the Inclusion Trust Protector the ability to change whether or not the Family Trust will be included in the Surviving Spouse's estate for estate tax purposes under 2041 of the Code, and whether or not the assets in the Family Trust will be treated as "property acquired from the decedent" under Section 1014(b) of the Code.

c. The Inclusion Trust Protector's powers, notwithstanding A.R.S. 14-10818, shall be strictly and exclusively limited to those provided for under this Article. Any Inclusion Trust Protector acting hereunder, pursuant to Arizona law, is not a trustee or fiduciary and is not liable or accountable as a trustee or fiduciary because of an act or omission of the Inclusion Trust Protector when performing or failing to perform the duties of a Inclusion Trust Protector under the trust instrument, and shall be subject to the protections under A.R.S. 14-10818(D). The Inclusion Trust Protector shall be entitled to reasonable compensation for any action actually taken hereunder, as well as reimbursement for any expenses incurred in acting hereunder.

d. My idea is that, by not specifically naming a Trust Protector, there is no concern about liability for that person (even though Arizona statutes clearly protect such an individual, and it is even more protected if there is no such position), but even more so, it avoids the difficulty of having to determine an appropriate independent party when drafting the documents. By granting the power to appoint to the remainder beneficiaries and having the power be granted to the survivor, there is effectively little chance that either "side" is going to gain power over the trust in any manner which would impact the substance.

V. The "Super Trust" at First Spouse.

A. Ultimately, most decisions for a couple without a significant estate tax issue will be, do I want the complexity of a Trust split, i.e., the creation of an irrevocable trust when the first spouse dies, or do I prefer simplicity. The benefit of the continuing complex arrangement is that the Trust is more protected, both from outside creditors and lawsuits, and to prevent the survivor doing something crazy and cutting out the kids. Where clients weigh these options and prefer the Irrevocable Trust, most of the time a Trust meeting these requirements will be the best fit:

1. The Trust should require all income and have no other beneficiaries during the survivor's lifetime, so it will qualify for the marital deduction.

2. It should not give the survivor a general power of appointment, so that it will not automatically be subject to estate tax at the survivor's death.

3. It should have principal distribution standards for the survivor, and a limited power of appointment that line up with the clients' wishes.

4. With these characteristics, the survivor will be able to decide whether to take a QTIP election when the first spouse dies. If they take that election, they preserve the deceased spouse's exemption through portability, which later can be applied to the assets in the trust, but, the QTIP will still get a step-up in cost basis as the survivor's death, not because of a general power of appointment, but because any asset for which a QTIP election is made is taxed under Section 2044.

5. Alternatively, the survivor may think that estate taxes are a more important issue, not take the QTIP election, and use the deceased spouse's exemption to keep the Trust estate tax exempt forever.

6. No matter which choice is made, either trust can be made GST exempt, preserving the deceased spouse's GST exemption which would otherwise be wasted. The Trust is protected from outside creditors, and limited to the beneficiaries set forth in the original plan, or granted under a limited power of appointment.

VI. "DECANTING": Panacea or Pitfall

(I.e., Oh no! What to do if you have an AB Trust (and do not want it) or do not have an AB Trust (and want it), or want change it?)

A. Decanting is the Power of a Trustee, as long as the Trustee has some distributive discretion to change the terms of the Trust, without changing the substance ***too much***, by either "pouring" the old trust assets into a new Trust, or, under Arizona's statute, by restating the terms of the Trust.

B. Everything we know about this power is included in the operative statute,

A.R.S.
§ 14-10819, which has been amended once already since its creation:

## 1. § 14-10819. Trustee's special power to appoint to other trust

a. Unless the terms of the instrument expressly provide otherwise, ***a trustee who has the discretion under the terms of a testamentary instrument or irrevocable inter vivos agreement to make distributions***, regardless of whether a standard is provided in the instrument or agreement, for the benefit of a beneficiary of the trust may exercise without prior court approval the trustee's discretion ***by appointing part or all of the estate trust in favor of a trustee of another trust*** if the exercise of this discretion:

(1) Does not reduce any fixed nondiscretionary income payment to a beneficiary.

(2) Does not alter any nondiscretionary annuity or unitrust payment to a beneficiary.

(3) Is in favor of the beneficiaries of the trust.

(4) Results in any ascertainable standard applicable for distributions from the trust being the same or more restrictive standard applicable for distributions from the recipient trust when the trustee exercising the power described in this subsection is a possible beneficiary under the standard.

(5) Does not ***adversely affect the tax treatment of the trust***, the trustee, the settlor or the beneficiaries.

(6) Does not violate the limitations on validity under sections 14-2901 and 14-2905.

(7) This section applies to a trust governed by the laws of this state, including a trust whose governing jurisdiction is transferred to this state.

(8) The exercise of the power to invade the principal of a trust under subsection A of this section is considered to be the exercise of a special power of appointment.

(9) The trustee, in the trustee's sole discretion, before or after the exercise of the trustee's discretion under this section, may request the court to approve the exercise.

(10) The trustee may exercise the discretion to appoint all of the trust estate pursuant to this section by restating the trust.

C. An important consideration to keep in mind that this is a Trustee’s power. Therefore it always subject to the fiduciary duties of a Trustee, unlike a Trust Protector’s power to make changes, or a beneficiary’s power to appoint and change the provisions of the document. Therefore, even when the terms of the statute allow a Trustee to “decant,” and the Trustee has the legal power, it does not always mean that it is appropriate to for the Trustee to exercise that power, especially in certain ways.

D. For illustrative purposes, imagine the Trustee has complete discretion to distribute income or principal to Johnny and Janey until 2025, at which time the trust assets get distributed ½ to Johnny and ½ to Janey.

1. According to a literal reading of the statute, the Trustee ***could*** decant this Trust into terms that say, during the discretionary period, Johnny is the primary beneficiary and Janey is a secondary beneficiary, and in 2025, the assets pass 80% to Johnny and 20% to Janey. Now, depending on what the limitation of “for the beneficiaries” means, it could be argued that this is permissive under the authority of the Decanting statute as a legal power. However, even if it is a legal power, it is probable the Trustee could be violating the Trustee’s duty of impartiality to the beneficiaries by decanting it into a more lopsided arrangement.

2. A very practical threshold to whether or not a Trust should be decanted is whether or not any of the original beneficiaries will be unhappy with the change. If so, the Trustee should be far more cautious as to whether or not it is really an appropriate action.

3. Morever, there are times where all beneficiaries want this type of change to be made, and, in that event, even if you do not want the

work of court approval, consider the beneficiaries signing off on the decanting so that the Trustee would not be held liable for a breach of Trust under Arizona law.

E. Sample waiver/release for consenting beneficiary:

1. I, **SUSIE BENEFICIARY**, a beneficiary of the Generous Settlor Trust Dated October 29, 2001, and furthermore, as a parent of all children of mine (including any minor or unborn children) who may ever have a beneficial interest in the Trust, pursuant to A.R.S. 14-1406, do hereby represent and bind any and all such children as to their beneficial interest, do hereby specifically consent to the Exercise of Special Power of Appointment dated ________, 2016, and the accompanying Restated Trust Agreement dated _________________, 2016. Furthermore, while the undersigned believes absolutely that the Exercise of Special Power of Appointment and Restated Trust Agreement are appropriate, the undersigned specifically consents (including on behalf of the undersigned's children) to the actions, thereby fully releasing the Trustee for any liability pursuant to A.R.S. 14-11009.

F. Given the nature of this power, one of the clearest changes permissible under a decanting power is to change the Trustees in essentially any manner. There are times, when this is the only change needed in a Trust, and one that is smaller and likely uncontroversial, where one might even shortcut this whole process into a simple amendment, where the Exercise states something to the effect of, "I hereby exercise the Special Power of Appointment to Restate the document, by incorporating all current provisions of the Trust Agreement as they are, except for the following change of Trustee."

G. The "adverse tax treatment" limitation is interesting, because it is very much dependent on a person's situation. Not that long ago, a tax general power of appointment over a Bypass Trust would have been a disastrous change causing estate taxation where there was none before. However, currently, most clients who have that type of arrangement will probably have no estate tax anyway, and the general power usually gives them a step-up for cost basis that will probably reduce income taxes.

H. When deciding to Restate or add to a new Trust, keep in mind whether you are trying to make it more or less likely that a person down the road could have a clear indication that there was a prior Trust.

I. Failure to Act? With attention to detail, it may be relatively easy to consider

> when exercising the power is an appropriate or safe use. What might be far more worrisome is the idea that, as a power granted to the Trustee, could the Trustee be liable for NOT decanting in a situation where it could be valuable. Given the typical analysis of a failure of fiduciary duties, a Trustee might be most vulnerable when he or she simply hadn't thought of decanting. If they've considered it and documented why it's not a good idea, that is probably safer.

For instance, imagine a Trust where there would be an income tax benefit if there was a step-up in cost basis when the beneficiary died. Could a Trustee be liable for not decanting in such a manner as to grant the beneficiary a general power of appointment? That's likely going to be a common issue with the increase in the estate tax limits.

## Section II - Estate administration and division of assets under formula clauses

7. So, now your client has died. The plan becomes reality. What to do first?

8. Division of community property assets

9. Once the trustee (with your help) has divided the trust assets between the survivor's community share and the decedent's share (includes the decedent's community share and the decedent's separate share), we can then move on to subdividing the decedent's share into the appropriate sub-trusts. This allocation, known as the funding formula, is specified in the trust document. There are two basic types of funding formulas:

    a. Pecuniary: Provides for an amount of the trust assets, which can be stated in a formula.

    b. Fractional: Provides for a division of the trust assets based on fractional shares.

    c. How can you tell a pecuniary formula from a fractional formula, especially when they both can be stated in terms of formulas, and in terms of fractions?

        i. Example One: A trust might provide that "The Credit Shelter Trust should be funded with one-half of the deceased spouse's gross estate."

        ii. Example Two: A trust might provide that "The Credit Shelter Trust should be funded with one-half of the deceased spouse's share of the trust corpus."

        The formula shown in Example One is a pecuniary formula. The formula shown in Example Two is a fractional formula. This is true even though both formulas refer to a fraction, "one-half'. The difference is that in the pecuniary formula, the value to which the fraction is being applied, the gross estate, is a fixed amount that will not change in value as the trust administration progresses, whereas the value to which the fraction is being applied in the fractional formula, the deceased spouse's share of the trust corpus, will change as income and expenses occur within the trust, and as the trust assets fluctuate in value.

Application of the funding formula to the date of death trust inventory will calculate the amount of each sub-trust's share as of the date of death. If funding of the trusts occurred instantly upon death, this would complete the funding calculation. We would then just allocate the assets to each share and we would be done. However, funding does not occur immediately, and the value of the trust corpus changes during the period of administration. Asset values go up or down, expenses get paid, and income is received. By the time the actual funding of the sub-trusts occurs, the asset mix and the values are different than they were on date of death. We then have to determine how to allocate the new mix of assets between the sub-trusts. That is where the methods of funding come into play. They are the link between the date of death calculations and the real-world, date of funding division of the assets between the shares.

10. Methods of funding (aka funding mechanisms):

   a. True Worth Pecuniary: assets are valued at their date of distribution values

      i. This method truly "freezes" the value of the pecuniary share, which is usually the marital share.

      ii. If the trust corpus appreciates during the period of administration, all of the appreciation goes to the residuary (usually bypass) share. Likewise, if the corpus depreciates, the residuary share shrinks.

      iii. This method can be used for a pecuniary bypass trust. It does not jeopardize the marital deduction (Rev. Rul. 90-3)

   b. Fairly Representative Pecuniary: assets are valued at their income tax basis, which is usually equal to the date of death value. In addition, the assets chosen for distribution must be "fairly representative" of the appreciation or depreciation between the date of death and the date of funding of all assets available for funding. In other words, the difference between the date of death value of the share and the date of funding value of the share must be roughly proportionate to the difference between the date of death value of all the assets available for funding and the date of funding value of all the assets available for funding (e.g. If the pool of assets has risen 20% in value, then each share's value must rise by about 20%).

i. Revenue Procedure 64-19 describes this method and rules that it is an acceptable method for funding a pecuniary marital share.

ii. This method results in the pecuniary share experiencing a proportionate share of the appreciation or depreciation of the trust corpus during the period of trust administration.

iii. This method can be used for a pecuniary bypass share (PLR 9007016).

Minimum Worth Pecuniary: each asset is valued for funding purposes at the lesser of the value at the date of distribution or the value at the date of death.

i. This method can result in more value being allocated to the pecuniary (usually marital) share than would be allocated under the True Worth or Fairly Representative methods.

ii. This method is never used for a pecuniary bypass trust, because it can underfund the marital share.

D. Fractional: assets are allocated so that each share corresponds to a specific fractional share of the residue, valued at the date of distribution.

i. Under Arizona law, when using the fractional method the trustee can use either a "pro rata" allocation of each asset to the fractional shares in accordance with the computed fractions, or a "pick and choose" method, whereby the trustee can allocate divided or undivided assets to the fractional shares.

11. What if the trust document doesn't specify the method of funding?

a. Absent any direction in the trust document, assets are valued for distribution purposes values on the date of distribution.

b. Arizona law provides that distributions may be made in kind, and can be made with divided or undivided interests in assets (ARS 14-10816(22)).

12. Valuing the assets

a. Generally, valuations of all the trust assets must be done as of date of death and again at date of funding and/or date of the division of the community.

i. Use of the True Worth Pecuniary or Minimum Worth Pecuniary methods of funding a marital share, with the residue to the bypass share, avoids the necessity of revaluing all of the assets at the date of distribution. Only the assets used for funding the marital share would need to be revalued.

b. Since it is impossible to value the assets and implement the funding simultaneously, this is generally handled by valuing the assets as close to the date of actual funding as possible. There is not a clear guideline for how close is "close enough". Presumably, if the values shift significantly between the date of valuation and the date of actual transfer, then the values should be recalculated.

13. Relevance of the choice of formulas and funding methods

a. Gain or loss on funding

i. Funding of a pecuniary share, when the asset is valued at date of funding value (True Worth Pecuniary and sometimes Minimum Worth Pecuniary) is considered to be a sale of the assets at its date of distribution value. Any resulting gain is taxable to the distributing trust.

ii. If the deemed sale results in a loss, the loss is allowable to an estate or to a trust electing under section 645 to be taxed as an estate, but is disallowed under the section 267 related party rules to a trust.

iii. Under fractional funding formulas:

The "pick and choose" method is only allowed if authorized by the trust document or state law (AZ does authorize this; ARS 14- 10816(22)).

If the "pick and choose" method is not authorized (in other states), then gain or loss can result if the trustee does not. adhere to the pro rata method.

If the "pick and choose" method is authorized, as it is in Arizona, then there is no gain or loss on funding the fractional shares (TAM 8447003).

14. Acceleration of IRD

a. Funding a pecuniary share with IRD assets will trigger the taxable income.

b. If the pecuniary share is the smaller share, this reduces the potential difficulty of having enough assets to fund the share without using IRD assets. Effective planning may be based on making the pecuniary share the smaller share.

c. Under fractional funding formulas if the "pick and choose" method is authorized, as it is in Arizona, then IRD is not accelerated.

15. Distributable Net Income (DNI)

i. Both pecuniary and fractional portions share in the distributable net income (DNI), but under different rules.

ii. Allocations of DNI are limited to the lesser of the fair market value of the assets distributed or their income tax basis.

iii. Separate share accounting is required for trusts and estates.

  i. To simplify the calculations, avoid interim partial distributions

16. Further allocation for GST purposes

a. After dividing the trust between community shares, and then dividing the decedent's share between marital and nonmarital (usually bypass) shares, it is often necessary to further divide the shares into GST-exempt and non-exempt shares. The trust document is generally silent on the method to be used to make this division. Since a pecuniary split is not specified, the funding is done on a fractional basis.

b. PLR 9007016 makes it clear that the IRS will approve of a fractional division that conforms to the principles of Rev. Proc. 64-19, using the concept of a "fairly representative" funding.

17. What if we get it wrong?

a. If we fund the shares incorrectly, the IRS can deem gifts to have been made between the beneficiaries of the shares (Rev. Rul. 84-105)

b. If we overfund the bypass trust, a portion of the bypass trust may be includable in the surviving spouse's estate (Bergeron v. Comr T.C.M. 1986-587)

c. Question: Should we be filing protective gift tax returns in the year of funding, disclosing the funding and the fact that there was no gift, in order to begin the statute of limitations?

18. Establishing the goals

When planning the funding, it is important to identify and weigh the various goals. Frequently, tradeoffs must be made because it is not possible to accomplish all of the goals.

a. Minimize surviving spouse's estate

i. Would argue for the allocation of growth assets to the bypass share. Query: do we always know which ones are growth assets?

ii. If the beneficiaries of the marital share are different than those of the bypass share, there could be some argument over the allocation of assets.

iii. Avoid allocating a fractionalized asset to a surviving spouse who already holds the other fraction of the same asset, because this will reduce or eliminate any discount for the fractional ownership. This may apply frequently to community property assets.

b. Provision of income to surviving spouse and/or other beneficiaries

c. Generational planning

i. Placing growth assets into the GST exempt trusts

19. Special types of assets

a. Retirement plans and other IRD assets

i. Generally allocate away from the pecuniary share
ii. Generally allocate away from the bypass share

b. S Corporations - will the receiving trust be an eligible shareholder?

c. Principal residence or vacation home

i. Consider allocating the residence or vacation home to the surviving spouse and then immediately entering into a QPRT, to minimize the survivor's estate

ii. Allocation of the principal residence to the survivor's grantor trust preserves the ability to use the section 121 exclusion

d. Family business

i. Division of the control may result in the sum of the shares being less than the total value per the estate tax return. This runs the risk that the marital share could be underfunded, resulting in the loss of some of the marital deduction and the imposition of estate tax (TAM 9050004, TAM 9403005)

e. Life insurance on surviving spouse - consider allocation to bypass trust, since this is a "growth" asset.

f. Passive activities

   i. The participation of the trustee determines whether the activity is considered passive.

   ii. Unused passive losses are added to basis of the property when it is distributed from the administrative trust, and do not pass through to the trust beneficiaries.

g. The personal checking account - since this has lots of personal activity, rather than leaving it in the trust, where we can we allocate it to the surviving spouse as of the date of death. Then we don't have to track all the personal expenses as part of the trust's activity.

20. Setting up reserve funds: It is advisable to hold a reserve for contingent liabilities for a period of time. This must be decided upon when the funding is being done.

   a. Amount of the reserve

      i. Requires careful assessment of potential claims

   b. How long to hold?

      i. Consider possible liabilities (malpractice, lawsuits, etc.)
      ii. Consider statute of limitations on tax liabilities.
      iii. Maybe file for prompt assessment.
      iv. Reserve probably not necessary if trustee is also the sole beneficiary

   c. Where to hold the reserve

      i. If small, consider holding in a non-interest bearing account, in order to avoid the necessity of filing income tax returns

   d. The reserve reduces the residuary share, which can be more than one beneficiary

21. Choosing the funding date

   a. Considering deemed date of death funding

      Handling the funding and filing the income tax returns as though the funding had occurred at the date of death can save the taxpayer some money in professional fees, since there is no need for an administrative trust tax return and no need to revalue the assets at the date of funding. The only problem is that there is no support for this position.

b. Once a funding date is chosen and the calculations are done, how far past that date can the actual transfers be and still be respected?

22. Reviewing the funding schedule

a. The whole team should be involved. The financial advisor should be consulted on the allocation of the assets.

b. To state the obvious, it's easier to fix the funding schedule than it is to undo and correct the trusts after assets have been moved.

## Section III – Investing in Formula Clause Trusts

Investment advisor's perspective and role in planning, implementation and maintenance of trusts created under formula clauses.

**Intro:**

As financial advisors, we view our role in the estate planning process as implementors, executors and collaborators. This boils down to 3 main areas where we can be effective partners for you all as estate planning attorneys and CPA's.

1. **Trust review and issue spotting.**

    a. This is extremely important for us when we are onboarding a new client. We have all seen the client come in and drop an estate plan on our desk and simultaneously blow the dust off the folder. Chances are it has not been looked at in quite some time. Our job is to review the current estate plan and ensure that it still satisfies the goals that the client is trying to achieve. If there is a mismatch, then we need to get them in contact with one of you and we can shift to becoming collaborators. An advisors role is to see if there are inconsistencies with what the current structure is and what the client is trying to achieve and then get them in contact with the right partners.

2. **Investing of trust assets.**

    a. Different investment considerations need to be taken into consideration depending on where we are at in the client life-cycle.
        i. Pre-funding investing vs. post-funding investing
    b. Post Funding investing for large estates vs. smaller estates

3. **Maintaining/executing the plan and acting as fiduciary not only to the client but to the beneficiaries as well.**

    a. Ongoing meetings with clients to ensure alignment of goals with estate plan
    b. Inform client on role as a trustee
    c. Family meetings with beneficiaries and providing meeting notes
    d. Role as a fiduciary to the client and fiduciary

1. ***Trust review and issue spotting***

    a. As a financial advisor, we want to ensure that we have copies of our clients' trust documents.

        i. It is our job and responsibility to review the trust documents to look for any issues that may be present so that we can get our clients in contact with an estate planning attorney to address any issues/shortfalls

    b. What we are looking for when reviewing:

        i. Ensuring overall intent is still the same
            1. Outright disbursements vs. keeping in trust for beneficiaries
            2. Have their priorities changed since the last time their estate plan was updated?
            3. Has their financial situation changed?
                a. Has their estate grown or have they inherited assets?
            4. Can current trustees named still act as trustees?
                a. Is a change warranted/corporate trustee
        ii. Does the trust reflect recent legislation changes?
            1. Secure Act 2.0 – if the trust is the beneficiary of the IRA, is there pass through language within the trust.
            2. Increase in estate tax exemption – is complexity still needed?
        iii. Understand their entire balance sheet
            1. Assets held in other states
            2. Identify separate assets vs community property assets
            3. Do they own unique assets
        iv. Review beneficiaries!
            1. Retirement accounts
            2. Investments such as non-qualified annuities
                a. Recently a client's mother had a non-qualified annuity with a substantial gain and the trust was the beneficiary.
                    i. That gain is now going to be taxed at the trust level vs the beneficiary level.
                    ii. In addition, they lost the ability for non-qualified non spousal stretch option

                    1. Instead of RMD’s at their age, they had to take it out within 5 years.
      v. If assets are going to be donated to charity, ensure that the charities still exist.

   c. Investment advisor’s role and responsibilities

      i. If we are working with a client who has either never established an estate plan or a lot of time has lapsed since the last time their trust was reviewed, we want to ensure that we are able to get them connected to one of you.
         1. Through the financial planning process, we are able to gain a deep understanding of the client’s goals and objectives and their current financial situation
      ii. Act as a partner/collaborator with estate planning attorneys/CPA’s
         1. Our role is not to decide overall trust structure/type

2. ***Investment perspectives and planning for the trusts created under formula clauses***

   a. Investment considerations pre-funding/death of one spouse
      i. Typically, a prudent conversation to have with clients who are older and where there is little to no risk of them spending down their assets is how their assets should be invested.
      ii. If there is no substantial risk of the funds being depleted, focus on growing and maximizing wealth creation for the beneficiaries vs. the perceived risk tolerance of the grantor
         1. Aligning the goals of the client vs. their risk tolerance
         2. The generic risk tolerance framework tells us that as a client gets older, their risk tolerance/exposure to equities should drop.
            a. Match asset allocation and risk exposure with clients intent/goals
      iii. Ensuring there is a plan for highly appreciated stock & concentrated stock positions
         1. Make sure that there are funding sources for the client so that they are not forced to sell highly appreciated stock that would be eligible for a step up in basis
            a. Possibly sell enough stock each year to fill lower capital gains tax brackets.

b. Smaller Estates

   i. Prior to the large increase in the estate exemption, much thought and consideration would need to be taken to determine how to invest the trust assets
   ii. If assets are split between an A and B Trust, determine with client the goals and objectives of B Trust

c. Large Estates - Balancing globally vs. by trust

   i. Discuss the importance of asset location in coordination with the overall asset allocation

      1. Looking at the totality of all trust assets, post funding and overall risk tolerance.
      2. Decide which trust accounts will be used primarily for surviving spouse living needs and rank them in order of access.
      3. Once overall allocation is determined, we would then shift our focus to each trust and the amount that they are funded with.
         a. If the overall asset allocation is determined to be 60/40, one could easily have each trust account invested similarly to reach this objective.
         b. Instead, look at each trust specifically to determine asset allocation
      4. Determine proper asset allocation, taking into consideration not only investable assets within the trusts, but also other portions of the clients' balance sheet
         a. A good example would be if an individual has a large real estate portfolio, from a general diversification stand point, we would take this into consideration when determining whether to include REITs in the investment allocation.
         b. Former executive with a large, concentrated stock position

   ii. Factor in what assets are includable in the surviving spouses estate vs which are no longer part of their estate.

      1. What is the remaining exemption of the surviving spouse

        2. Balancing the need for short-term liquidity needs of a surviving spouse and long-term appreciation for beneficiaries.
        3. Prior to funding, as Evelyn mentioned, this is where investment advisors can collaborate on the funding schedule.

    iii. Understanding the needs of the beneficiaries
        1. Do they have a need for income now or would they benefit more from long-term appreciation?

    iv. Striking the right balance between growth assets that will be subject to a step-up in basis vs. potential estate tax on the appreciation of the assets.

    v. Provide a sample "global report" and walk through the overall asset allocation and then how each underlying trust/account is invested to meet

    vi. The importance of having a "quarterback" if there are trust accounts split across various investment advisors.
        1. Ensure that all investment advisors are working in coordination with each other to achieve the stated asset allocation and investment objectives established by the Trustees.
            a. Reduces potential risks and/or duplicative investment strategies.

**3. Maintaining/executing the plan and acting as fiduciary not only to the client but to the beneficiaries as well.**

a. Collaborating when funding schedule is being determined
b. Ongoing meetings with clients to ensure continued alignment of goals with initial strategy
    i. Like any other aspect of financial planning, as life events happen, meeting regularly to ensure that the initial strategy is reviewed and adjusted as needed
    ii. Changes to the original strategy being discussed
        1. Continue working with CPA and estate planning attorney
    iii. Making necessary changes considering any potential legislative changes
    iv. If both spouses are still living
        1. Review estate plan flow chart with asset overlay

c. Inform client on role as a trustee
    i. Ensure that the Trustee understands their role and responsibilities as the trustee
d. Family meetings with beneficiaries and Trustees
    i. Helps ensure that everyone is on the same page with the overall strategy
    ii. Aligns risk tolerance with both the beneficiaries and trustee
    iii. Helps satisfy Trustees fiduciary obligations to beneficiaries
    iv. Provide documentation and meeting notes for all parties involved

# Case studies

***The Case of the Boilerpoint Formula Plan:***

Mary Everyman consults you when her husband, Joe, dies unexpectedly at the young(ish) age of 63. They recently moved to Arizona from Connecticut after Joe retired from a career as an electrician. They have a house (fmv $600k), Joe's IRA (fmv $2m), and a brokerage account (fmv $800k). They have been married for 40 years and have no children together.

Mary assures you that their estate plan is all in place, having been done by an attorney in Connecticut who has since retired. She brings you the notebook. It's several inches thick but most of the personal data is "fill in the blank" style with a different typeset and a few blanks here and there. Mary said the Connecticut attorney had assured them that these documents would save them from the 50% death tax and would "take care of Mary" after Joe was gone.

You read the documents. Joe has a pour-over will, and a revocable trust established by Joe (remember, Connecticut is a separate property state). Joe's trust provides that at his death a pecuniary credit shelter trust is to be funded to the extent of the estate tax exemption, with any excess going to a QTIP marital trust for Mary's benefit during her lifetime (HEMS standard). The credit shelter trust provides for income only to Mary during her lifetime and following her death, residue for the benefit of Joe's descendants.

***Then you find out:***

Mary mentions that Joe had a son from a brief first marriage, but they've lost touch long ago.

The IRA has no beneficiary designation.

Mary shares with you that she was born in Canada but has lived in the U.S. since she was a baby. She never needed to apply for citizenship; as a stay-at-home wife the issue just never came up.

***The Case of the Mix and Match Beneficiaries***

You are consulted by Junior Richman, the son of a successful local business owner. Junior's mother, Hester Richman (age 56), had founded and operated a chain of vegan restaurants which had expanded to a five-state franchise operation. Hester was married at the time of her passing to Pierre Portence (her fourth husband), a chef who helped run the business. Junior explains that he has two younger half-sisters (Missy and Sybil) from Hester's second and third marriages. Missy has two children. Junior and Sybil have no children.

Hester's will and trust provide for a pecuniary (true worth funding mechanism) credit shelter trust to be funded to the maximum amount possible without resulting in any estate tax, and a residuary marital trust. Junior is named as sole trustee of the administrative trust.

The marital trust provides for income only to Pierre under a HEMS standard (no discretion for principal distributions). The marital trust passes 50% to charity and 50% to grandchildren upon the surviving spouse's death. Pierre is named as the sole trustee of the marital trust.

The credit shelter trust provides for discretionary income and principal. The credit shelter trust is for the benefit of Junior and Sybil, remainder to grandchildren; Junior is named as sole trustee.

Hester's property consists of:

a. Vegan Kitchens Extraordinaire stock (S corporation) 100% - fmv $12m after a 40% valuation discount (value before discount of $20m)
b. IRA - $8m (all in growth stocks)- named beneficiary is Hester's Trust
c. Principal residence – fmv $4m
d. Art collection – fmv $4m
Total gross estate $28m (no prior gifts)

If (big IF) all the property is Hester's separate property, then the formula Math as of date of death is Pecuniary Credit Shelter Trust $14m and Residuary Marital Trust $14m.

***Questions/potential issues:***

1. What is the community property share?
2. Would funding the pecuniary share with the discounted S corporation shares be fair to the marital trust?
3. True worth pecuniary funding requires valuation at date of distribution. If that appraisal applies a smaller valuation discount will the estate tax auditor challenge the date of death value?
4. If the marital trust is funded with a fraction of the S corp stock will the marital deduction be challenged?
5. Does Junior have conflicts of interest?