Dividing Trusts into Subtrusts

A. **Overview:** This memo provides direction to a trustee of a revocable trust where the trust requires the allocation of trust assets into two or more subtrusts at the time of the settlor's death, or, in the case of a two-settlor trust, at the time of the settlor who dies first. Traditionally, this type of planning has been done by married couples, but it also works for domestic partners and unrelated individuals. However, planning involving a trust that qualifies for the marital deduction for federal estate tax purposes only applies if the surviving settlor is married to the deceased settlor.

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

(b) Federal Estate Tax. The federal estate tax rate is currently 40%. The amount of property that can be transferred free of the estate tax is referred to as the "applicable exclusion amount", which is $11,400,000 in 2019, and $11,580,000 in 2020.

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

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

(a) *Survivor's Trust.* The Survivor's Trust or Trust A receives all of the surviving settlor's assets (50% of the community property and 100% of the surviving settlor's separate property) plus the decedent's assets to the extent the value exceeds the applicable exclusion amount. Generally, the surviving settlor will have the right to amend and revoke only the Survivor's Trust. This trust is usually designed to qualify for the estate tax marital deduction if the settlors are married at the time of the first death of a settlor.

(b) *Decedent's Trust*. The Decedent's Trust or Trust B receives as much of the deceased settlor's property (50% of the community property and 100% of the deceased settlor's separate property) that can pass free of the estate tax. This is done primarily so that the decedent's "applicable exclusion amount" is preserved without further estate taxation and without being subject to the claims of a beneficiary's creditors or to dissipation in a beneficiary's divorce proceeding. The surviving settlor may be and usually is the beneficiary of the Decedent's Trust, and the trust may permit the surviving settlor to direct distributions from the trust either during the surviving settlor's lifetime or after the surviving settlor's death or both.

B.2 A/B/C Trust. An A/B/C trust is only for couples who are married. Upon the decedent's death, the typical A/B/C Trust or A/B/QTIP divides into three subtrusts.

(a) Survivor's Trust. In a typical A/B/C Trust, the Survivor's Trust or Trust A is a trust for the surviving settlor's assets, and the surviving spouse designates the beneficiaries upon the survivor's death. This trust receives all of the surviving settlor's assets but none of the decedent's assets.

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

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

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

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

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

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

D.1 Fractional Formula. The formula can provide for a division of the trust into "fractional shares" so that each subtrust owns a fractional interest of each asset. The advantage of this formula is that the division is a mathematical division that appears in the trust's accounting records, but specific asset allocations are unnecessary. The disadvantage of this method is the need to have your accountant update the fraction every time you distribute assets from one of the subtrusts.

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

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

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

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

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

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

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

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

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

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

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

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

F. **Conclusion:** To preserve the estate tax planning in a trust, the trust provisions relating to divisions into subtrusts must be meticulously followed. Annual tax returns for each irrevocable trust must be file to keep asset allocations up-to-date and properly documented so that each subtrust's assets or property interests are clearly segregated and identifiable.

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