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Tax-Saving AB Trusts*

Couples can save a bundle on estate taxes with this kind of living trust, called an AB trust or marital bypass trust.

Most people don't need to think about federal estate tax because it only affects those with very large estates. But if you (or you and your spouse) expect that your estate may owe taxes, creating an AB trust is a good way to both avoid probate and also save on federal estate tax.

How an AB Trust Works

Here's how it works: Instead of leaving property outright to the surviving spouse, each spouse leaves most or all of his or her property to an irrevocable trust that can be used for the benefit of the surviving spouse. Because the surviving spouse does not own the property outright, the property isn't subject to estate tax when the surviving spouse dies.

When setting up an AB trust, each spouse names final beneficiaries who will receive the trust's property when the surviving spouse dies. Spouses often name the same people -- their children -- as final beneficiaries, but it's not mandatory.

Example

Christine and Terry have a combined estate of \$4 million, all of which they own together. If each left his or her half, \$2 million, to the surviving spouse outright, that spouse would be left with an estate of \$4 million. If the surviving spouse dies in 2009, when the estate tax threshold is \$3.5 million, \$500,000 would be subject to estate tax.

But if Christine and Terry each leave their half of the trust property in an AB trust, naming their five children as the trust's final beneficiaries, no estate tax will be due. Let's say Christine dies in 2009. Her \$2 million goes into an irrevocable trust for Terry, and is subject to estate tax at that time. But because the amount in the irrevocable trust is less than the federal estate tax exemption, no tax is due. Similarly, when Terry dies later that year, his \$2 million is also less than the exempt amount.

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The Surviving Spouse's Rights

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

At most, the surviving spouse may:

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

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

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

Drawbacks of an AB Trust

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

Possible drawbacks include:

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

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

Do You Need an AB Trust?

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

Other couples who may not need an AB trust include:

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