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Marital Trust: An Estate Planning Tool

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Everybody has the right to pass property from one generation to another. However, this right is subject to federal estate and gift taxes and to Missouri estate taxes. Estate planning has two purposes:

- To provide for orderly distribution of property.
- To reduce the effect of taxes on this distribution of property.

This publication discusses an estate planning tool called the marital trust. A marital trust can reduce the impact of estate taxes and provide professional management for assets passed at death. This publication emphasizes the recent federal estate and gift tax changes caused by the Economic Recovery Tax Act of 1981.

A more detailed description of the objectives of estate planning and the various tools available to the professional estate planner is in MU publication M00068, *Estate Planning for Missouri Families*. However, neither M00068 nor this publication is a substitute for the help and guidance of a professional estate planner such as your attorney, accountant or bank trust officer.

What is a trust?

A trust is a legal arrangement that authorizes one or more people (called trustees) to manage property for the benefit of the beneficiaries. Once the original owner has placed property in the trust, the original owner is called the settlor. The trustee manages the property and pays the earnings of the trust property to the beneficiaries of the trust according to the terms of the trust document. This trust document is simply a written agreement between the settlor and the trustee specifying details of trust management and payments to beneficiaries.

Types of trust. Although various trusts are designed to accomplish different objectives, trusts generally fall into two categories: inter vivos and testamentary. Inter vivos trusts (also called living trusts) are those established by the settlor during his or her lifetime. These trusts may or may not be revocable and are designed to pay the trust's income to the settlor or to other beneficiaries. Inter vivos trusts begin functioning during the settlor's life and often continue after death.

The second type of trust is the testamentary trust. Testamentary trusts are established upon the settlor's death and are generally part of the settlor's will. The marital trust is a testamentary trust because it does not come into being until the settlor's death and because it is generally written into a will.

What is a marital trust? A marital trust is an arrangement whereby a married individual has some or all property put into trust upon her or his death with the spouse as the beneficiary. (For simplicity, this publication will refer to the first spouse to die in the male gender. The surviving spouse will be referred to in the female gender.) This is commonly done by dividing the property into two portions, held in two separate trusts. One trust is called the marital deduction trust and the other the remainder trust. Usually, the income from both trusts is paid to the surviving spouse for life. However, the power of control over the two trusts varies substantially, and these differences have a major effect on estate tax liability. The objective of a marital trust is to decrease the aggregate total estate taxes paid by a couple upon their deaths.

Using the marital trust

As mentioned earlier, estate planning provides for orderly distribution of assets at death. This includes not only the distribution of assets upon the death of the first spouse but also the distribution of assets upon the death of the surviving spouse. Because the first spouse's estate can take advantage of the estate tax marital deduction, but the estate of the unmarried survivor cannot, most estate tax problems do not arise until the death of the surviving spouse. Therefore, estate planning should be family estate planning.

How the marital trust works. The marital trust can be tailored to meet the needs of different people. A basic marital trust arrangement is described in this publication to demonstrate how it can be used.

Generally, in a marital trust arrangement, the first spouse's property is divided into two separate portions.

One portion is used to create a marital deduction trust. This trust takes advantage of the estate tax marital deduction. The Economic Recovery Tax Act of 1981 exempts all transfers between married couples from estate and gift taxes.

To qualify for the marital deduction, the property must pass to the surviving spouse outright, or the surviving spouse must be given a general power of appointment over the property. A general power of appointment means that the surviving spouse has the power to appoint or give the property to anyone she chooses, including herself. If the surviving spouse has general power of appointment over the marital deduction trust, then the property in the trust will not be taxed upon the death of the first spouse. However, it will be subject to estate taxation upon the death of the surviving spouse.

The remaining portion of the property of the first spouse to die is used to create a second trust, called a remainder trust. Property placed in the remainder trust is taxed upon the death of the settlor.

However, if the amount of property in the remainder trust is less than the amount covered by the unified credit (\$275,000 in 1983), there will be no tax due. The remainder trust property generates income, which is usually paid to the surviving spouse for the rest of her life. The surviving spouse has no power over the remainder trust, except for the right to receive income from the trust for life.

When the surviving spouse dies, the remainder trust property passes to the ultimate beneficiaries named by the settlor. The remainder trust property is not included in the surviving spouse's estate upon her death. This last fact is the crucial reason a dual trust format can decrease the total estate taxes paid by a couple. The marital deduction trust reduces the estate taxes paid by the first spouse to die, while the remainder trust reduces the estate taxes paid by the surviving spouse.

By using the marital deduction and the remainder trusts, a couple can reap other benefits. The remainder trust property will not go through probate upon the surviving spouse's death. This results in a savings on probate expenses, attorney's fees and other related estate administration expenses.

Also, a selected professional trustee can manage the trust property. This is particularly wise if the trust property consists of a farm or business and if the surviving spouse is unfamiliar with its operation. The surviving spouse is often selected as trustee, but make sure that the remainder trust does not have to be included in the surviving spouse's estate.

Power of control. The differences in the power of control over the marital deduction and the remainder trusts are crucial. Any person, with the power to vest or allocate the ownership of the trust property in himself, will be treated as the owner of the trust property. When the holder of such a power dies, the trust property subject to the power must be included in his estate.

The marital deduction property is included in the estate of the surviving spouse. So giving the surviving spouse the power to vest the ownership of the marital deduction trust property in herself will not affect the tax consequences of the marital deduction trust. However, this is not true for the remainder trust.

The remainder trust property is not included in the surviving spouse's estate, unless the surviving spouse has the power to vest the ownership of the remainder trust property in herself. Thus, when the surviving spouse dies, there will be estate tax savings, if the surviving spouse is not given such a power in the remainder trust.

A surviving spouse can have a special power of appointment over the remainder trust. Under a special power of appointment, the surviving spouse can allocate or vest the ownership of the trust property to any or all members of a special group, as long as it does not include the surviving spouse, her estate or her creditors. Commonly, the group is limited to the settlor's children and grandchildren. When the surviving spouse has a special power of appointment over the remainder trust, it is not included in her gross estate.

The trustees of the remainder and the marital deduction trusts can be given the power to invade or encroach upon the trust property for the benefit of the surviving spouse. However, if the surviving spouse is to be the trustee, then this encroachment power must be limited by an ascertainable standard. This standard must relate to her health, education, support or maintenance.

The trustees of both trusts should be given the power to sell the trust property, if it is earning insufficient income or profit. The trustees should be required to hold the proceeds from the sale in the same trust and should be given a duty to re-invest such proceeds promptly. This power of sale gives them the investment flexibility needed to properly administer a long-term trust.

How much property should be in the marital deduction trust? How successful the marital trust arrangement is in reducing estate taxes depends on the amount of property in the marital deduction and the remainder trusts.

The Economic Recovery Tax Act of 1981 created an unlimited marital deduction. It also increased the amount of the unified transfer tax credit (see Table 1). In planning a marital trust, the objective is to balance the marital deduction and the unified credit to minimize the aggregate total of estate taxes paid by a couple upon their deaths.

Table 1. Unified transfer tax credit.

Year	Tax credit	Corresponding taxable estate equivalent
1982	\$ 62,800	\$225,000
1983	79,300	275,000
1984	96,300	325,000
1985	121,800	400,000
1986	155,800	500,000
1987 and later	192,800	600,000

Under a marital trust arrangement, the goal is to maximize the amount of property in the remainder trust. The value of the property in the remainder trust should equal the corresponding estate value for the year of death (listed in Table 1).

For example, if John dies in 1983, then \$275,000 of his estate can create the remainder trust without any estate tax liability. The balance of John's estate would create the marital deduction trust without any estate tax liability. The marital trust arrangement is most effective if as much property as possible is used to create the remainder trust. However, the value of the property in the remainder trust should not exceed the amount that can be offset by the unified credit applicable for the year of death (see Table 1).

Why is this so? Under the marital trust arrangement, only the property put in the marital deduction trust is taxable when the surviving spouse dies. The remainder trust property passes to the beneficiaries named by the settlor (usually the children) free of estate taxes at the death of the surviving spouse. Therefore, if estate taxes can be avoided when the first spouse dies by making full use of the unified credit to cover the remainder trust property, and if the marital deduction trust is used only for any excess, less property will be subject to estate taxes when the surviving spouse dies.

Income for life. The surviving spouse can receive income from all of the property, whether it is in the marital deduction or the remainder trust. Also, special provisions allow the surviving spouse to use some principal of the remainder trust without having the trust property included in her estate. Thus, allocation of the property between the marital deduction and the remainder trusts does not materially affect the income that the surviving spouse receives during her lifetime. Shifting property between the two trusts mainly affects the amount of property subject to federal estate taxes on the death of the surviving spouse.

Formula clause. Before 1982, the estate tax marital deduction was equal to one-half of the adjusted gross estate. Then, many marital trust arrangements provided for a quantity of the adjusted gross estate to be placed in the marital deduction trust. That way full use or advantage was taken of the estate tax marital deduction.

The unlimited marital deduction established under the Economic Recovery Tax Act of 1981 changes those marital trust arrangements. The new law provides a transition rule, but relying on this grandfather provision is not recommended. Any will or trust with a formula clause should be revised as soon as possible. Your attorney can help review your present estate plan in light of the 1981 tax changes and can recommend appropriate changes in your estate plan.

Ownership form. Most husbands and wives hold their property as joint tenants or more frequently as tenants by the entireties. The main feature of holding property in these forms of ownership is the right of survivorship. Right of survivorship means that when one tenant dies, the other tenant automatically acquires the whole property. Distribution of the right of survivorship property cannot be controlled by a will or a trust. The 1981 Act clarified the taxation of right of survivorship property by treating a husband and wife co-ownership either in joint tenancy or in tenancy by the entireties as a 50-50 split. This way only half of such property is included in the estate of the first spouse to die. However, it makes the survivor's estate include 100 percent of the property because no remainder trust can be created. Owners can avoid this result if they hold the property as tenants in common.

A tenant in common can leave his share of the property to his heirs by using a will or a trust. By changing the ownership form of property to a tenancy in common when a comprehensive estate plan is set up, several estate tax problems can be avoided. Also, the right to direct who inherits property can be retained. Consult an attorney about the advantages and disadvantages of such a change in the ownership form.

Marital trust example

This example shows how a marital trust arrangement can reduce or eliminate federal estate taxes (see Table 2). Assume that no lifetime gifts have been made. Also, assume that the husband dies in 1983, his widow dies in 1984 and the husband owned all the property at his death.

Notice that the date of death determines the amount of the unified tax credit available to offset estate taxes. As Table 1 shows, a larger unified tax credit is available to the surviving spouse who lives until the next calendar year.

Table 2. Use of a two-portion marital trust.

	Option 1 Using a marital-remainder trust		Option 2 (Husband wills entire estate to wife)	
	Husband (1983)	Wife (1984)	Husband (1983)	Wife (1984)
Gross estate	\$650,000	\$329,500	\$650,000	\$604,500
Minus deductions ¹	45,500	23,065	45,500	42,315
Adjusted gross estate	\$604,500	\$306,435	\$604,500	\$562,185
Less marital deduction (placed in marital trust)	329,500	0	604,500	0
Taxable estate (placed in remainder trust)	\$275,000	\$306,435	0	\$562,185
Calculated taxes	\$79,300	\$89,988	0	\$178,808
Minus unified credit	\$(79,300)	\$(96,300)	\$(79,300)	\$(96,300)
Taxes due	0	0	0	\$82,508

¹Assume deductible expenses of 7 percent of gross income.

Both Option 1 and 2 are similar in their practical consequences. Under both, the surviving spouse receives all the income generated by the property. However, Option 2 results in \$82,508 more estate taxes. Also, Option 1 has lower probate expenses because the \$275,000 of property in the remainder trust does not go through probate when the surviving spouse dies. According to the trust document, it passes to the heirs named by the trust settlor.

Additional considerations. First, the creation and management of a marital trust arrangement costs money. Compare the cost of the marital trust to the federal estate tax savings which would result from the use of a marital trust.

Second, the marital trust arrangement is most effective when the first spouse to die owns a significant portion of the property. For this reason, a husband and wife should discuss with their attorney the portioning of the assets between husband and wife while both are still living.

The Economic Recovery Tax Act of 1981 exempts all transfers between spouses from estate and gift tax liability. Thus, such a portioning would be exempt from taxation. After the assets have been divided between spouses, reciprocal marital trust arrangements can be drawn up to reduce federal estate taxes no matter which spouse dies first. In portioning their assets, the husband and wife, with their attorney's advice, should consider changing the form of ownership of the property to tenancy in common or individual ownership.

Third, life insurance can drastically change an estate plan. When the insured spouse dies, the life insurance proceeds may have to be included in the estate, and so they are subject to estate taxes. This problem increases when the value of the life insurance policy increases.

To keep life insurance proceeds from being included in the insured's estate, he must irrevocably relinquish all incidents of ownership over the policy during his lifetime. Incidents of ownership include the power to change beneficiaries, to revoke the policy, and to borrow against the policy. The most common method for an insured to relinquish the incidents of ownership is by a gift of the policy to a family member. The family member receiving the policy (the donee) should pay all premiums. If the insured continues to pay the premium after the gift, a portion of the life insurance proceeds will have to be included in the insured's estate at his death.

Consult an attorney in any situation where a gift of a life insurance policy is being contemplated.

Finally, a husband and wife can minimize estate and gift taxes by giving gifts during their lifetimes. The Economic Recovery Tax Act of 1981 allows a married couple to give \$20,000 a year to each donee without incurring gift tax liability. A surviving, unmarried spouse can give \$10,000 a year to each donee without incurring gift tax liability. These gifts decrease the taxable estate of both spouses.

For more information

Estate planning should result in a family estate plan that foresees the effects of federal estate taxes on estate assets not only at the death of the first spouse but also at the death of the surviving spouse. The marital trust as a tool that can be particularly important in saving estate tax dollars.

For more estate planning information, refer to MU publications M00068, *Estate Planning for Missouri Families*, and G00505, *Farmland Valuation for Estate Tax Purposes*. Seek professional guidance in making your estate plan. Estate planning is a complicated endeavor not to be attempted without the advice of your attorney and other professional advisers.

To order, request G00504, *Marital Trust: An Estate Planning Tool* (50 cents).

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