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Perspectives

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The Art of Estate Planning Using Formulas

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What is your most important estate planning goal? To ensure that your spouse is cared for financially and physically? To minimize federal estate and gift tax? To minimize income tax and capital gains tax? To make sure that your children from a previous marriage are not disinherited? To carry on a financial legacy for future generations? To care for a disabled or troubled child? The list could go on and on with the reality that we all have estate planning goals that are personal to us and specific to our unique family circumstances and dynamics. Different goals may run parallel to each other in terms of importance, and the goals will likely be multi-layered.

"What is your most important estate planning goal?"

Our goals sometimes are not formed into perfect puzzle pieces that fit together to achieve the optimal result. Because goals may compete with each other, we may have to compromise and accept that estate planning is more of an art than it is a science. We have to work with what we know today and do our best to anticipate how to achieve optimal results in the future, especially with the ever-changing tax landscape.

A prime example of the complex combination of art and science in estate planning is when we consider the use of formulas to fund an estate plan. The funding formula that is part of your trust document is important because it will dictate how assets will pass to your surviving spouse (or children), which in turn will have an impact on capital gains tax planning, income tax planning and beneficiary expectations. The formula selected can create flexibility (or inflexibility) in the administration of your estate plan.

There are two basic formulas used when funding a trust estate that result in a marital trust share and the family trust share: the pecuniary formula and the fractional share formula. To understand these formulas, it's important to know what comprise the marital trust share and the family trust share. The marital trust share passes to the surviving spouse to be used as the survivor wishes, and disposed of as the survivor directs, unless a Qualified Terminable Interest Property (QTIP) provision is included in the trust document that allows the decedent to control final disposition of the assets after the survivor's death. The family trust share is held with some strings attached for distribution to the surviving spouse and ultimate disposition of the assets on the survivor's death. A closer look at the impact of these funding formulas on the marital trust share and on the family trust share will help you decide if a conversation is needed with your trust officer or estate planning attorney to determine if your most important goals will be met with the formula clause used in your existing estate plan.

When a pecuniary formula is used in a trust document, the formula identifies and guarantees a specific sum to the marital trust share or family trust share of an estate plan by stating that the share will be funded with an amount that will result in the least amount of federal estate taxes. For example, the family trust is funded with the maximum amount of the federal estate tax exemption, currently up to $11.18 million in 2018. In trust estates where the decedent's trust assets are $11.18 million or less, the entire amount will fund the family trust, which leaves no assets transferred to the marital trust. The sum certainly means that you will know that no more than $11.18 million in assets will be transferred to the family trust.

In contrast, the fractional share formula instructs that a fractional share relative to the total value of the trust estate is transferred to the marital trust share and family trust share. One example of a fractional share formula may result in 20% of each asset be transferred into the marital trust share, and 80% of each asset into the family trust share. The fraction must be recomputed each time a distribution is made from either share until the estate is terminated by a complete distribution. As you can imagine, utilizing the fractional share formula can make trust administration quite complex; however, it may achieve the desired results and is worth the effort.

The impact on an estate plan of each of these formulas will achieve very different results depending on the beneficiaries and the nature of the decedent's assets. Below are a few examples to consider.

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Impact to Surviving Spouse

Should the pecuniary formula be used in a trust estate that has less than $11.18 million, the entire amount will be transferred into the family trust and zero to the marital trust. Adequate consideration should be given to whether or not the surviving spouse will have enough in his or her estate, so as not to create a feeling of loss of control, or a perceived lack of financial resources.

Impact on Capital Gains Taxes

When an individual dies, the assets he or she owns receive a new income tax cost basis for purposes of computing future capital gains tax. This new tax basis is the fair market value of the asset as valued on the date of the individual's death. This reduces or eliminates the capital gain recognized on the sale of the asset by the beneficiary. The formula used in the trust could deprive a second income tax basis adjustment on the survivor's death.

Impact on Income Taxes

When choosing a funding formula consideration needs to be given to the types of assets held in an individual's estate so that income tax recognition is not inadvertently accelerated. For example, with a pecuniary formula, if post-death asset appreciation is used, in part, to fund a trust share, the use of that post-death appreciation will cause the trust or estate to recognize capital gain. Or, if IRA assets are used to satisfy a pecuniary funding formula, that will cause all of the IRA assets used in the trust funding to be taxed as ordinary income. Both will result in the acceleration of income taxes.

There are many drafting choices to be made in the context of an individual's most important estate planning goals. Just the basics of trust funding formulas are discussed here and there is much more to consider when choosing a funding formula. The funding formula utilized can become incredibly complex yet financially beneficial should the correct formula be followed. The types of assets held in a decedent's trust estate and the complex array of outcomes desired contributes greatly to the most beneficial formula for you. With the addition of portability of a deceased spouse's unused estate tax exemption, and the $11.18 million federal estate tax exemption, a review of your estate plan with your trust officer or estate planning attorney may prove to be beneficial to best determine if both art and science are best being combined to achieve your desired goals.