Trust Funding Formulae

Take-Away: The choice of a funding formula in a trust, often with a marital deduction trust funding formula can affect how the bequest is funded. Similarly, a trust funding formula can be used to fund a nonspousal trust, e.g., a credit shelter trust, or simply a pecuniary, i.e., dollar amount bequest, allocated to an individual.

Background: Funding formulae used in a trust instrument often leave the settlor (and beneficiaries) moving their lips as they read its paragraphs as they try to decipher its implications. This short missive attempts to simplify the types of formula to choose from and the implications of each formula when it comes to administering a decedent's trust.

It is safe to say that there is no single right or wrong answer as to which formula to use, but some thought should go into that choice (or at least reasons provided why which funding formula was selected.) For ease of explanation, the missive assumes that *subtrusts* will be funded using a decedent's trust's allocation funding formula.

Fractional Bequest: This formula bequest is described as a basic fraction (no surprise!) It uses words to identify a numerator and the denominator of the fraction. This means, (at least in theory) that each beneficiary (or recipient subtrust) is entitled to an undivided interest in each asset (usually consisting of the decedent's entire trust estate.) As a result, the trust assets are allocated proportionately among the separate shares or subtrusts.

Administrative Benefits: From a trustee's administrative point of view, a fractional formula means that the trust assets do not have to be revalued if the allocation is achieved proportionately between the subtrusts. From the beneficiary's point of view a fractional formula means that taxes, claims against the estate, debts, administrative expenses, *and post-death appreciation* (or post-death depreciation) are shared proportionately between the different subtrusts the formula directs the trustee to fund using trust assets.

Type of Assets Might Dictate Use: A fractional formula is best used if: (i) capital gains are expected to be generated by the trust's assets; (ii) an IRA or a 401(k) account is going to be

allocated between the subtrusts, since there is no recognition of income at the time the subtrusts are funded using those assets as part of the allocation; and (iii) the fair market value of the trust assets will be used at the time of funding (more on this below) which means that the decedent's estate cannot finalize the funding of the recipient subtrusts (or financial bequests) until there is an IRS closing letter.

Pecuniary Amount: A pecuniary bequest is a gift, or allocation, of an actual dollar amount. It can be stated as an amount, e.g., "$4.0 million," or it can be described using a word formula, e.g., " I give the smallest amount to the marital trust that will not cause any federal estate tax to be paid on my death, if my wife survives me."

Capital Gain Exposure: If the trust assets appreciate in value prior to the funding of the subtrust that is to receive the pecuniary amount, the use of appreciated trust assets to satisfy that pecuniary amount will trigger capital gain recognition by the trust.

Administration Challenges: In addition, when using a pecuniary amount formula, the assets will have be valued both for the date of death (to satisfy the IRS) and then valued a second time when the assets fund the pecuniary amount bequest. This is problematic if there are hard-to-value assets as part of the decedent's trust, or if valuation discounts were used to value those assets for federal estate tax reporting purposes. The beneficiaries, while delighted that a valuation discount was used to lower federal estate taxes, will not be happy if the same valuation discount is used to fund their pecuniary bequest, leading to a lower amount. Consequently, there are more administrative costs incurred for the second appraisal that is required for the pecuniary bequest and more hassled when beneficiaries get confused when different values are used (for their subtrust funding, compared to values used to determine federal estate tax liability.)

Post-Death Appreciation: Because a fixed dollar amount is used as part of this pecuniary formula, if the trust assets appreciate after the settlor's death, the residuary subtrust gets that appreciation, or the residuary subtrust suffers if there is any depreciation of trust assets before the funding date. Restated, if trust assets go up in value before funding, the residuary subtrust takes more, or it gets less if the trust assets drop in value prior to the fund of the subtrusts. Trying to explain this possibility to trust beneficiaries of the pecuniary amount subtrust is always a challenge.

Variations: To make matters even more complicated, there are two different types of pecuniary trust funding formulae.

True Worth: One is called the **true worth** pecuniary formula. This pecuniary amount is satisfied using the values at the date of distribution. That means the pecuniary amount is fixed and does not receive any upside (appreciation) or downside (depreciation.) Instead, the subtrust that receives the residuary assets after the pecuniary amount is funded enjoys, or suffers, any change in trust values. This means that income in respect of a decedent (IRD), like IRAs are going to have the recognition of income as soon as they are used to fund any pecuniary amount. Accordingly, a **true worth** pecuniary formula should not be used if there are large IRD assets as part of the decedent's trust, e.g., IRAs, 401(k)s, or deferred compensation if they are going to pass under the pecuniary formula.

Fairly Representative: The other variant of a pecuniary formula is called the **fairly representative** pecuniary formula. It is a pecuniary amount that uses values as finally determined for federal estate or income tax purposes. However, the condition is that the assets allocated to that pecuniary portion (or subtrust) have to fairly represent the appreciation or the depreciation of the trust assets that are available for subtrust funding. This does not mean that the trustee has to allocate proportionate shares, though that can be the easiest solution, but the trustee can pick and choose, to try to get the assets 'outside' the pecuniary portion or share. The burden is on the trustee to confirm that the overall values in the pecuniary amount reflect both the appreciation and depreciation since the date the funding was done.

Conclusion: There can be very different results based on which trust funding formula is selected. Using the same allocation formula for each individual makes no sense, inasmuch as their assets and circumstances are always different. It is important to choose a trust funding formula and then identify for the settlor the reasons why that formula was selected.

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