

# **Trusts That Affect Estate Administration**

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# **I. When Trusts are Included in the Estate**

## **A. Marital Trust (also known as an A Trust)**

1. Definition: A marital trust that is a trust that qualifies for the unlimited marital deduction so long as the surviving spouse is a U.S. citizen, is the only beneficiary of the trust during his or her lifetime, and has the right to receive income from the trust during his or her lifetime. A marital trust is typically funded upon death with the amount of the deceased spouse's assets that exceed his or her available federal and/or state estate tax exemption amount. The assets remaining in a marital trust are subject to estate tax at the second spouse's death. The deceased spouse may direct who receives the remainder of the trust assets after the death of the surviving spouse or may grant the surviving spouse a general or limited power of appointment to direct who receives the remainder of the trust assets after his or her death.

2. Qualified Terminable Interest Property (QTIP) Trust: A QTIP trust is a type of marital trust in which the surviving spouse must receive all of the income from the trust, the surviving spouse may direct the Trustee to make the trust assets income-producing, and the deceased spouse controls who receives the remainder of the trust assets after the death of the surviving spouse. In order to qualify as a QTIP trust, an election must be made on the deceased spouse's estate tax return.

3. Maryland-only QTIP Trust: A Maryland-only QTIP Trust is type of trust that was created after the state estate tax was decoupled from the federal estate tax. The purpose is to hold the deceased spouse's assets that exceed his state estate tax exemption amount (\$2 million in 2016) but are less than his or her available federal estate tax exemption amount (\$5.45 million in 2016). This enables a married couple to maximize the amount that they can shelter from federal estate tax while avoiding state estate tax at the first spouse's death because this trust is treated like a credit shelter trust for federal estate tax purposes and a marital trust for state estate tax purposes.

4. General Power of Appointment Trust: This type of marital trust allows the surviving spouse to appoint trust assets to himself or his estate.

B. Credit Shelter Trust (also known as Bypass Trust, Family Trust, or B Trust)

1. Definition: A credit shelter trust is a trust that is funded at the death of the first spouse to die with assets that will be considered to be part of the deceased spouse's taxable estate. The purpose is to reduce a married couple's overall estate tax liability by using some or all of the first spouse to die's available federal and/or state estate tax exemption rather than leaving everything outright to the surviving spouse. Typically the surviving spouse and children are beneficiaries of a credit shelter trust. Assets remaining in a credit shelter trust at the death of the surviving spouse will not be subject to estate tax, but also are not eligible for a step-up in tax basis at the death of the surviving spouse.

2. Credit shelter trust v. portability: Portability enables a personal representative of a deceased spouse to elect on the decedent's federal estate tax return to transfer the deceased spouse's unused federal estate and gift tax exemption (referred to as DSUE) to the surviving spouse. This provision became permanent under the American Taxpayer Relief Act of 2012. To elect portability, a federal estate tax return must be filed, even if one is not otherwise required, within nine months of the deceased spouse's death. Portability is much simpler than a credit shelter trust, but has some significant drawbacks: (a) portability is not available for the generation-skipping tax exemption, (b) portability does not apply to unused state estate tax exemptions, (c) portability does not provide any asset protection to the surviving spouse, (d) portability is eliminated if the surviving spouse remarries, (e) it is possible that the federal estate and gift tax exemption amount will decrease in the future, and (f) the deceased spouse has no control over who will receive his or her assets upon the death of the surviving spouse.

## C. Use of Disclaimer Trust Planning

1. Purpose: The purpose of using disclaimer trusts in estate planning is to provide flexibility to the surviving spouse to determine at the death of the first spouse whether to disclaim some or all of the assets that will transfer from the deceased spouse (whether through the estate, a revocable trust, joint tenancy, or beneficiary designation) into a bypass trust for estate tax reasons. The benefit is that the surviving spouse can assess what the estate tax laws are and the size of the deceased spouse's and surviving spouse's estates before being locked into funding a trust. This tool is especially valuable now because of the scheduled increase in the Maryland estate tax exemption amount and the annual adjustments for inflation in the federal estate tax exemption amount.
2. Mechanics: Each spouse's will designates the other as the outright beneficiary of his or her estate and gives the surviving spouse the option to disclaim a portion of the assets into a bypass trust.
3. Restrictions:
  - a) This type of disclaimer is only available to a surviving spouse because other individuals are not permitted to have the right to benefit from disclaimed property.
  - b) The surviving spouse must disclaim his or her interest within nine months of the deceased spouse's death and must not have accepted the benefits of the property prior to disclaiming it.
  - c) The surviving spouse cannot retain a testamentary power of appointment over the trust assets.

## D. Revocable Trusts (also known as Living Trusts or Inter Vivos Trusts)

1. Definition: A revocable trust is a trust created during the lifetime of the Settlor that can be altered or revoked by the Settlor. The assets held in a revocable trust are treated as belonging to the Settlor for estate, gift, and income tax purposes.

2. Advantages of revocable trusts: (a) avoid probate for assets held in trust, (b) enable someone else to manage assets in the event of the Settlor's disability, (c) simplify the process of transitioning assets to beneficiaries after death, (d) protect privacy because the information regarding assets in the trust is not publicly available, and (e) result in allowable Trustee fees that are typically lower than allowable personal representative commissions.

3. Limitations of revocable trusts: (a) do not avoid estate taxes, (b) do not protect assets from the Settlor's creditors, (c) require more time and money to set up than a traditional estate plan, (d) cannot be used to name a guardian for minor children, and (e) do not replace a will or financial power of attorney.

## **II. What Must be Done When a Trust Becomes Irrevocable**

A. Obtain Federal Employee Identification Number (EIN):

1. How to apply: Apply online at <https://sa.www4.irs.gov/modetein/individual/index.jsp>. If anyone other than the Trustee or grantor is applying for a federal employee identification number on behalf of the trust, then he must obtain a completed Form SS-4 from the Trustee or grantor before applying as a third-party designee on behalf of the trust.

2. When an EIN is not necessary: If revocable trust assets will be distributed in-kind to beneficiaries within a short period of time after the trust becomes irrevocable, then it is generally not necessary to obtain an EIN.

B. File Tax Returns: The Trustee of an irrevocable trust must file a IRS Form 1041 to report trust income if the trust earned more than \$600 during the tax year. The Trustee must also file a Schedule K-1 and deliver copies to each beneficiary who received a distribution from the trust during the tax year.

C. Notice Provisions under the Maryland Trust Act: Section 813(b)(ii) of the Maryland Trust Act requires that the Trustee shall notify all qualified beneficiaries (as defined in Section 14.5-103(r) of the Maryland Trust Act) within ninety (90) days of the creation of an irrevocable trust (or of a revocable trust becoming irrevocable) that such trust was created by the Settlor and is revocable (or became irrevocable as a result of the Settlor's death). See Attachment A for a sample notice to beneficiaries.

1. Required information in notice: The notice must identify the Trustee, provide the Trustee's contact information, and indicate that the qualified beneficiary has the right to request a copy of the trust instrument and a Trustee's report annually, upon termination of the trust, and upon a vacancy in the office of Trustee.
2. Delivery of notice: Such notice shall be given by personal delivery or certified mail with return receipt requested.
3. Beneficiaries or whereabouts of beneficiaries unknown: If the names and/or addresses of the qualified beneficiaries are unknown, then such notice shall be given by publication in a newspaper of general circulation in the county where the trust is located once a week for three successive weeks.

D. Publication of Notice to Creditors: If the trust is a revocable trust that became irrevocable upon the death of the Settlor, then the trust is subject to the claims of creditors of the Settlor and his estate. However, the claims period can be limited in two ways:

1. Claims of creditors when the Settlor's estate is a regular estate (or proceeds under modified administration): In this instance, the claims of creditors against the trust are subject to the same limitations as claims of creditors against the estate. These limitations are governed by Section 8-103 of the Estates and Trusts Article of the Annotated Code of Maryland, and are limited to the

earlier of (a) six months from the decedent's death<sup>1</sup>, or (b) two months from actual notice to the creditor.

2. Claims of creditors when no estate or a small estate is opened for the Settlor: In this instance, claims of creditors can be limited under Section 14.5-508 of the Estates and Trusts Article of the Annotated Code of Maryland by filing a notice to creditors once per week for three successive weeks in a newspaper of general circulation in what would otherwise be the proper venue for the administrative or judicial probate of the decedent. See Attachment B for a copy of the statutory notice. The claims period for creditors against the trust will be limited to six months from the date of the first publication of the notice to creditors.

### **III. Post-Mortem Trust Funding**

#### **A. Assets to Fund Trusts:**

1. Probate assets: Probate assets include all assets that (a) are owned by an individual at his or her death and are not otherwise designated by joint tenancy, contract, or beneficiary designation, or (b) name the estate as the beneficiary, or (c) default to the estate as a result of the lack of named beneficiary. A person may direct in his will that probate assets will be transferred to a testamentary or inter vivos trust. In addition, a surviving spouse may have the option to disclaim her interest in some or all of the assets to which she is entitled under the deceased spouse's will into a bypass trust.

2. Assets that name the trust as a beneficiary: A testamentary or inter vivos trust can be named as the beneficiary of assets such as retirement plans or life insurance. These assets are not considered to be probate assets even when the testamentary trust is named as the beneficiary.

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<sup>1</sup> Although the statute limits the claims of creditors to six months from the decedent's date of death, the Register of Wills offices require estates to remain open for a period of six months from the time that an estate is opened and Letters of Administration are issued.

3. Non-probate assets that are disclaimed: Assets that are jointly titled or that have beneficiaries designated may be disclaimed by a beneficiary. A disclaimer has the effect of acting as though the joint owner or designated beneficiary predeceased the decedent. As a result, the deceased owner's share of jointly titled property will transfer into his probate estate, and his will may direct all probate assets into a trust. In the case of a designated beneficiary, the asset will transfer to the contingent beneficiary, and if none, to the decedent's probate estate (unless the plan documents direct otherwise for certain retirement accounts or life insurance contracts). Because disclaimers are irrevocable once made, it is critical to ensure that the disclaimed asset will go where intended before being disclaimed.

4. Assets in a revocable trust: Assets in a revocable trust (or directed to a revocable trust upon the death of the Settlor) may be utilized to fund irrevocable trusts after the Settlor's death.

B. Formula Clauses

1. Pecuniary formulas: This type of formula involves funding either the marital or credit shelter trust with a fixed amount, and allocating the remainder to the other trust (or outright to the surviving spouse). There are variations depending upon whether the trust is funded based on the value of the assets at the valuation date, at the date of distribution, or a formula that fairly reflects the net appreciation and depreciation of assets between the valuation date and date of distribution.

2. Fractional share formulas: This type of formula allocates the trust assets on a percentage basis between the marital and credit shelter trust unless specific language allows different assets and disproportionate shares of specific assets to be used to fund each share.



C. Non-estate Tax Considerations for Funding Trusts:

1. Capital gains tax: Because credit shelter trusts do not provide for a second step-up in tax basis at the death of the surviving spouse, it may be desirable to fund the credit shelter trust with assets that are less likely to substantially appreciate between the spouses' deaths. Assets that are likely to increase in value are better suited for the marital trust because a marital trust that is includable in the surviving spouse's taxable estate receives a second step-up in tax basis at the surviving spouse's death. However, the capital gains benefits must be weighed against the estate tax implications of placing assets in one type of trust versus the other.

2. Income tax:

a) Trust v. individual income tax rates: If a trust asset produces income and that income remains in the trust, it will be taxed at the trust's income tax rate. A trust will be subject to the maximum income tax rate of 39.6% after producing only \$12,400 of taxable income in 2016. In addition, trusts may be subject to the 3.8% net investment income tax on top of the 39.6% income tax. Therefore, it is generally preferable for income-producing investments to be held in a trust where the Trustee is required (or is likely to) distribute income to beneficiaries.

b) Benefit of bypass trust: Allocating income-producing assets to a bypass trust allows the Trustee to have the flexibility to allocate income to the beneficiary with the lowest federal income tax brackets and/or lower or no state income tax. In a marital trust, all income must pass to the spouse and cannot be shifted to other beneficiaries.

c) Retirement plan distribution: As described in further detail in Section IV below, a trust needs to satisfy certain criteria in order to distributions to be stretched out over the beneficiary's life expectancy. If a trust that does not qualify for this type of distribution is named as a beneficiary, then the distribution timeframe is greatly compressed and will have negative income tax consequences to the beneficiary.

## IV. IRA Designated Beneficiary Trust (DBT)

A. Definition: A qualified trust that is named as a beneficiary of an IRA. This type of trust is also known as a see-through trust.

B. Purpose: If properly drafted, the trust will qualify for the maximum stretch-out of required minimum distributions<sup>2</sup> (RMDs) over the oldest<sup>3</sup> beneficiary's life expectancy. This will allow the retirement funds to continue to grow in a tax-deferred manner for an extended period of time.<sup>4</sup> In addition, it can be used to name the final beneficiary of an IRA, avoid poor financial management by the beneficiary, protect against claims of creditors<sup>5</sup> and divorcing spouses, preserve a beneficiary's need-based public benefits, and qualify as a generation-skipping transfer for estate tax purposes.

C. Qualifications: In order to qualify as a DBT, the trust must meet the following four requirements as set forth in Treasury Regulation 1.401(a)(9)-4, Q&A-5:

1. The trust must be valid under state law.

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<sup>2</sup> IRA account owners must begin taking required minimum distributions by April 1<sup>st</sup> of the year following the year that the account owner reaches 70 ½. The rules governing distribution after the death of the IRA account owner depend upon whether the IRA account owner had begun taking RMDs and who is named as the beneficiary. See Attachment C for an IRS chart of RMDs for IRA beneficiaries and Attachment D for the IRS Single Life Expectancy Table.

<sup>3</sup> If a trust has multiple beneficiaries and a beneficiary's interest is severable, then such beneficiary's share can be stretched out over his or her individual life expectancy. Separate shares must be established by December 31<sup>st</sup> of the year following the year of the IRA owner's death.

<sup>4</sup> If the trust that is named as a beneficiary does not qualify as a DBT, then it must distribute the IRA assets as follows: (1) if the IRA account owner dies before he or she was required to begin taking RMDs, then the IRA must be fully distributed within five years; (2) if the IRA account owner dies after he or she was required to begin taking RMDs, then the IRA must be fully distributed within the remaining life expectancy of the deceased IRA account owner.

<sup>5</sup> In *Clark v. Rameker*, 134 S. Ct. 2242 (2014), the Supreme Court held that inherited IRAs would not receive protection from creditors as "retirement funds" under the Bankruptcy Code.

2. The trust must be irrevocable or must become irrevocable upon the death of the original owner of the IRA. The IRA owner can maintain the ability to change the IRA beneficiary during his or her lifetime. In addition, the trust may be created at the death of the IRA owner via a testamentary trust.

3. The trust's beneficiaries must all be identifiable and must be eligible to be designated beneficiaries. The beneficiaries do not need to be individually named as long as they are part of a class of beneficiaries that would be identifiable (such as "my grandchildren") at the IRA when necessary. To be eligible as designated beneficiaries, the trust's beneficiaries must be individual people and cannot be charities, estates, or other types of entities that do not have a life expectancy.

4. Trust documentation must be provided to the IRA custodian by October 31<sup>st</sup> of the year following the year of the IRA owner's death. The trust documentation must include a final list of all trust beneficiaries as of the determination date, which is September 30<sup>th</sup> of the year after the IRA owner's death. In addition, the Trustee must either provide a copy of the trust agreement or certification that all requirements for stretch distributions are met to the IRA custodian.

#### D. Conduit Trust v. Accumulation Trust

1. A conduit trust is a trust that names remainder beneficiaries but directs that all required minimum distributions collected from the IRA will pass through directly and immediately to the underlying beneficiary. The rule for this type of trust is that all remainder beneficiaries can be ignored for the purpose of determining the oldest life expectancy.

2. An accumulation trust is a trust that can accumulate the required minimum distributions and may not pass them through to the beneficiaries until a later date. The rule for this type of trust is that the current and remainder beneficiaries must be considered when determining life expectancy (until the point where an outright distribution occurs). This is problematic if a charity or other entity is named as a remainder beneficiary before outright distribution occurs because the trust would not qualify as a DBT. This is also problematic from an income tax perspective because if an RMD is not distributed to a beneficiary, it will be taxed at the trust's income tax rate rather than at the beneficiary's income tax rate.