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FREQUENTLY ASKED QUESTIONS

About

Tax-Planned Wills With Second Generation Planning

What is the "Tax Free Amount" and What is the "Marital Deduction Amount"?

Estate tax planning for married couples usually involves dividing *the estate of the first spouse to die* into two shares. (The estate plan can be set out either in a Will or in a revocable (living) trust–we will just use the term, "Will," to refer to both instruments in this memo.) Remember that most, if not all, assets on hand when the first spouse dies are likely to be community property. Therefore, *the estate of the first spouse to die* consists of the deceased spouse's half of the community property plus his/her separate property, if any. One share of *the estate of the first spouse to die* is the portion of the deceased spouse's estate that is exempt from the federal estate tax. Assuming no "taxable gifts" were made during life, this amount is $13,610,000 in 2024 (this amount is indexed for inflation and will change in future years–it will also "sunset" at the end of 2025). This amount can be referred to as the "Tax Free Amount." The balance of the estate, i.e., the amount *out of the estate of the first spouse to die* that exceeds the Tax Free Amount (if any) is usually left either to the surviving spouse, outright, or to a Marital Trust for the surviving spouse, to defer estate taxes on that excess amount until the death of the surviving spouse through application of the estate tax marital deduction. This excess amount can be referred to as the "Marital Deduction Amount." The decision whether to leave the Marital Deduction Amount outright to the surviving spouse or to a Marital Trust is based primarily on (i) the total value of the excess amount (is it sufficient to justify another trust?), (ii) the need or desire to protect the excess amount from creditors' claims (such as a tort creditor who sues the surviving spouse and obtains a judgment), and (iii) the first spouse's desire for "ultimate control"–to control where the assets remaining in the Marital Trust go when the surviving spouse dies (or, put another way, to prevent the surviving spouse from directing the assets to persons chosen by the surviving spouse, such as a new spouse).

What is a Bypass Trust?

A Bypass Trust is a trust designed to hold the Tax Free Amount of the first spouse to die. The surviving spouse or any other qualified person or entity may serve as trustee of a correctly drafted Bypass Trust. Per the terms of the typical Bypass Trust, distributions can be made to the surviving spouse to provide for his or her health, support and maintenance in accordance with his or her accustomed standard of living. If the Bypass Trust is so drafted, distributions can also be made to children and other descendants from the Bypass Trust, as "secondary" beneficiaries. Those secondary beneficiaries are often in lower tax brackets than the trust itself and the surviving spouse. Thus, including a power to make distributions from the Bypass Trust to children and grandchildren sets up the possibility of trust income being taxed at very low rates. When trust income is distributed out of the trust to a permissible beneficiary, the beneficiary pays income tax on the distributed income, not the trust. The surviving spouse is sometimes given a testamentary "power of appointment" (described below) over the Bypass Trust. In spite of the fact that the surviving spouse has use of the Bypass Trust assets during his/her lifetime (and may be given control over the disposition of the Bypass Trust assets at death through a testamentary "limited" power of appointment), the assets in the Bypass Trust will not be included in the surviving spouse's estate upon his/her death. In this way, the Bypass Trust assets "bypass" estate taxes on both spouses' deaths. Note that the Bypass Trust assets avoid estate taxes on the death of the surviving spouse no matter what the trust assets are worth at that time (i.e., the value of the Bypass Trust can exceed the Tax Free Amount when the surviving spouse dies and still not incur estate taxes).

What is a Marital Trust?

A Marital Trust is a trust designed to hold the Marital Deduction Amount, i.e., the portion of the deceased spouse's estate *in excess of* the "Tax Free Amount" (if any). The value of the assets passing to a Marital Trust is deducted from the taxable estate of the first spouse to die, effectively deferring estate taxes on the Marital Trust assets until the death of the surviving spouse. The surviving spouse or any other qualified person or entity may serve as trustee of a correctly drafted Marital Trust. Per federal tax law, all (net) income earned by the Marital Trust assets must be distributed to the surviving spouse each year. Distributions of principal can usually also be made to the surviving spouse from the Marital Trust to provide for his/her health, support and maintenance in accordance with his/her accustomed standard of living. Upon the death of the surviving spouse, the assets in the Marital Trust (on which estate tax was deferred when the first spouse died), as well as the surviving spouse's individually owned assets, will be included in the surviving spouse's estate and subject to estate taxes to the extent the total value exceeds the surviving spouse's Tax Free Amount.

As a result of the Tax Cuts and Jobs Act passed in December 2017, which increased the basic estate tax exclusion amount to $10 million, adjusted for inflation, for years 2018 through 2025 (after 2025, the estate tax exclusion amount will revert back to $5 million, indexed for inflation), some married couples prefer to use a Marital Trust, rather than a Bypass Trust, for the entire amount owned by the first spouse to die. The primary reason to do that is to obtain a second "adjustment" to income tax basis for the assets held in the Marital Trust when the surviving spouse dies. If the assets have increased in value by the time of the surviving spouse's death, that adjustment will be a "step up" in basis. In view of the fact that the Marital Trust assets will be included in the surviving spouse's estate (unless the executor of the deceased spouse's estate elects otherwise), if it appears that one exemption from the federal estate tax will not be sufficient to avoid estate taxes on the surviving spouse's death, the executor of the deceased spouse's estate can file a federal estate tax return (Form 706) within nine months of the deceased spouse's death and make the portability election. When the portability election is made, the deceased spouse's unused exemption amount (which is the full amount passing into the Marital Trust plus all amounts passing directly to the surviving spouse, assuming the surviving spouse is a US citizen) can be transported to the surviving spouse, which will result in the surviving spouse having more than just one exemption from the estate tax when the surviving spouse dies.

When deciding between a Marital Trust and outright gifts to the surviving spouse, there are both tax and non-tax reasons for choosing a Marital Trust. Like all irrevocable trusts, the Marital Trust can be designed to protect the assets from loss due to a divorce or other lawsuit, can provide for management of the trust assets in the event the surviving spouse loses his or her mental capacity or is not financially astute, and can protect the trust assets from being diverted to a new spouse of the surviving spouse or to other persons who the deceased spouse does not want to benefit. In addition, use of a Marital Trust can facilitate "second generation planning" (see below).

What are Children's Trusts or Descendant's Trusts?

Most Wills, other than very simple Wills, provide for "Descendant's Trusts" for children, grandchildren and other descendants. Descendant's Trusts are "lifetime protective trusts." Some Wills call a lifetime trust for a child a "Child's Trust" and call a lifetime trust for a grandchild a "Grandchild's Trust." However, both lifetime trusts for children and lifetime trusts for grandchildren (and other descendants) can be called, "Descendant's Trusts" (and will be referred to as "Descendant's Trusts" in the rest of this memo). In any case, each child or other particular descendant is usually the named primary beneficiary of his/her own separate Descendant's Trust. The primary beneficiary's own children and other descendants are often included as additional (secondary) beneficiaries of the primary beneficiary's Descendant's Trust to whom distributions can be made while the primary beneficiary is living. This adds flexibility and increases the income tax options. When the primary beneficiary dies, the assets remaining in his/her Descendant's Trust will usually be distributed to his/her children, but it is typical to give the primary beneficiary of a Descendant's Trust a testamentary power of appointment (*see* below).

In Wills *without* second generation planning, "Contingent Trusts" are used (*see* below). Contingent Trusts terminate when the beneficiary reaches the specified termination age (such as age 25). Until the Contingent Trust terminates, the trust protects the beneficiary, just like a Descendant's Trust. However, when a Contingent Trust terminates, all of the protections are lost. Thus, Descendant's Trusts continue the benefits of the trust structure for the beneficiary's entire life (and, often, for the lives of the beneficiary's children and grandchildren, too).

What is Second Generation Planning?

In Wills containing "Second Generation Planning," Descendant's Trusts are lifetime trusts. Because each beneficiary's trust lasts for his/her entire life, the protections and benefits that the trust provides last for the beneficiary's entire life, too. Second Generation Planning also refers to the fact that a couple can plan to avoid federal estate taxes on their assets both in their own combined estate and in the estates of their children (and even their grandchildren) when they die.

What Are the Terms of a Typical Descendant's Trust?

Descendant's Trusts with second generation planning (a/k/a "second generation trusts" and "GST trusts") are very flexible. The typical trust has the following terms:

- Each named beneficiary (each child or other descendant) is the primary beneficiary of his/her own separate Descendant's Trust for his/her entire lifetime.

- Usually, the children and other descendants of the primary beneficiary are named as secondary beneficiaries of the primary beneficiary's Descendant's Trust while the primary beneficiary is living. This means that distributions may be made to them from the beneficiary's Descendant's Trust, too.

- Distributions of income and principal can be made to any of the trust beneficiaries to provide for their health, education, support, and maintenance, in their accustomed standard of living. In some cases, customized distribution provisions are permissible.

- If the beneficiary of a Descendant's Trust is "too young" to have control over his/her trust, then someone else–a relative, a bank, a private trust company, or any other qualified person or entity--is appointed as the initial trustee of the beneficiary's Descendant's Trust. However, it is customary to give the primary beneficiary the right to become a co-trustee of his/her trust at a certain age (such as 25 or 30) and the right to become the sole trustee of his/her trust at a later age (such as 30 or 35). Serving as a co-trustee for a certain number of years before becoming the co-trustee can be good training.

- The beneficiary usually has a testamentary "power of appointment" (described below) over his/her trust.

- There will be more income tax options with respect to trust income because there is more than one potential income taxpayer. Any beneficiary who receives a distribution of income from the trust will pay income taxes on the share of income he/she receives in his/her own income tax bracket. To the extent that trust income is distributed out of the trust, the trust will not pay income taxes on that distribution (it's an "either/or" situation and *not* a "double tax" situation).

What Are the Non-Tax Benefits of the Typical Descendant's Trust?

There are significant non-tax benefits to the typical Descendant's Trust, such as:

- *Creditor protection*. The trust assets will not be subject to claims of the beneficiary's creditors, so that a large judgment obtained in a lawsuit against the beneficiary will not result in the beneficiary losing the benefits of the inherited assets (to the extent they are still held in the trust).

- *Divorce protection*. If the beneficiary is married, assets retained in the trust will be trust property, not marital property. Therefore, the trust assets are generally beyond the reach of Texas divorce courts.

- *Control*. If there are concerns that a particular beneficiary might disinherit his/her own children, that beneficiary's trust can be drafted without a testamentary power of appointment, or the power of appointment can be limited in scope, thus ensuring that, upon the beneficiary's death, the assets remaining in the beneficiary's trust will be distributed to his/her children.

- *Management assistance*. If a particular beneficiary is not sufficiently skilled (or inclined) to manage his/her trust, that beneficiary's trust can be drafted without giving the beneficiary the power to become the trustee of his/her own trust, thus ensuring that the trust will be managed by a professional (or otherwise qualified) trustee.

- *Guardianship avoidance*. If a beneficiary becomes incapacitated, the successor trustee of the beneficiary's trust can manage the trust and provide for the beneficiary's needs. Additionally, the assets held in the beneficiary's trust would not be subject to a court-supervised guardianship of the beneficiary's estate.

What Are the Tax Benefits of the Typical Descendant's Trust?

Without second generation planning, if you leave assets outright to your children and they preserve those assets during their lives, there may be an estate tax on those assets upon their deaths. Your estate (or, the combined estate of you and your spouse) may already have paid estate taxes on those same assets when the surviving spouse died. Under current law, with second generation planning, an individual can shelter an aggregate amount of up to $13,610,000, and a couple can shelter an aggregate amount up to $27,220,000 (2024 amount), from all future estate taxes that would otherwise be due upon those assets upon the deaths of your children and grandchildren. This amount is called the "GST exemption."

This estate tax avoidance extends to the initial $13,610,000 (2024 amount) *plus whatever that amount grows to during the lives of your children*. Upon a child's death, assuming proper allocation of each spouse's GST exemption, the full amount remaining in the child's trust passes estate tax free to new Descendant's Trusts for the child's children. This preserves the GST exemption so that, on each grandchild's death, the trust assets pass estate tax free to the great-grandchildren.

In addition, since the typical Descendant's Trust has multiple beneficiaries (the primary beneficiary and all of his/her children and other descendants), there are multiple potential taxpayers with respect to paying income taxes on the income earned by the trust assets each year (i.e., more income tax options). The income tax liability basically follows the income. So, if the trustee distributes the trust income to one or more of the permissible beneficiaries of the trust, each beneficiary who receives a share of that year's trust income will pay income taxes on the share he/she received, in his/her own income tax bracket. Some of the beneficiaries could be in very low income tax brackets, especially compared to the trust itself, which must pay income taxes on the income it retains. And even if the trust only has one current beneficiary, there are still two potential income taxpayers, the trust itself and the beneficiary, so that the trust's income can be split between the two. When assets pass directly (outright) to beneficiaries, there are no income tax options–all income earned by the inherited assets will be taxable to the beneficiary as the owner of the assets.

Thus, with second generation planning, each generation has use of the trust assets during life and, usually, control over the disposition of the trust assets at death (through exercise of the power of appointment), yet those assets are protected from creditors' claims and spouses suing for a divorce, and are distributed estate tax free to the next generation (subject to the initial limits noted above). Plus, there are more income tax options.

What Are Contingent Trusts?

"Contingent Trusts" are simple trusts included in most Wills for beneficiaries who need a trust, but who are not covered by any other trusts created in the Will. It would practically be considered legal malpractice for a Will not to have a Contingent Trust in it, at the very least. Contingent Trusts terminate when the beneficiary reaches the specified termination age (such as age 25); however, it is also common for a Contingent Trust to have multiple staged terminations (e.g., ⅓ at age 25, ½ of the balance at age 30, and the balance at age 35). During the term of the Contingent Trust, the trustee makes distributions from the trust to or for the benefit of the beneficiary for his/her health, support, maintenance and education. If the beneficiary dies before reaching the trust termination age, the assets in the beneficiary's Contingent Trust will usually be distributed to his/her children, if any, otherwise to his/her siblings. In "simple" Wills, Contingent Trusts typically apply to a person who might inherit any assets who is either "too young" (such as a minor) or mentally incapacitated. In Wills with Second Generation Planning, Contingent Trusts usually apply to persons *other than* children, grandchildren and other descendants (because Descendant's Trusts, which are "higher quality trusts," are used for descendants). When a Contingent Trust terminates due to the beneficiary reaching the specified age, all trust assets are distributed to the beneficiary, outright and free of trust. Thus, all trust benefits expire at that time.

What Is a Power of Appointment?

A "power of appointment" gives the beneficiary of a trust the power to decide to whom the trust's assets will be distributed, either while the trust is still in existence (an inter vivos power of appointment) or when the trust terminates on the beneficiary's death (a testamentary power of appointment). A "testamentary" power of appointment usually must be exercised in the beneficiary's Will and, as noted, the power only becomes effective on the beneficiary's death. Powers of appointment may be "limited" so that the group of people to whom the trust assets may be given is restricted, or "general" so that the beneficiary may give the trust assets to his/her estate, and thereby, to anyone named in his/her Will. Possessing and/or exercising a limited power of appointment has no tax consequences for the beneficiary, while merely possessing a general power of appointment makes the trust assets includable in the beneficiary's estate at death (sometimes that is done on purpose, to avoid the more onerous GST tax, for example). One benefit of giving the primary trust beneficiary a testamentary power of appointment over his/her trust is that the beneficiary can address changes that have occurred over time. Since many trusts last for a very long period of time, changes may need to be made to the distribution of the trust assets on the beneficiary's death. For example, suppose a trust beneficiary has two children. Sometime after the beneficiary's trust was established, one of the beneficiary's children invents a popular product and becomes very wealthy, while the beneficiary's other child develops a debilitating disease that prevents that child from working and results in large expenses each year. The "default" in the instrument that created the trust is likely to provide that the assets in the beneficiary's trust are to be distributed in equal shares to his/her two children upon his/her death. By exercising the testamentary power of appointment, the beneficiary can change that default distribution and provide a larger share (and a special needs trust, if applicable) for his/her child who is seriously ill.

What Is a Fiduciary?

"Fiduciary" is the generic term applied to anyone acting on behalf of another to manage assets that have been entrusted to the Fiduciary. Most Wills appoint two types of fiduciaries: An "Executor" and a "Trustee." The Executor is the person generally responsible for handling the "post-death process," which involves collecting and preserving your assets, filing all required tax returns (for you and for your estate), winding up your affairs, and fulfilling the provisions of your Will (i.e., establishing and funding the trusts created in your Will, re-titling and distributing assets to the proper recipients, etc.). The Trustee is the person responsible for the more long term job of administering the trusts you create (i.e., managing investments, making distributions to the beneficiaries of the trust, filing income tax returns for the trust, etc.). The same person can be both a Fiduciary and a beneficiary, and the same person can be both an Executor and a Trustee. Different trusts can have different Trustees.

What is a Guardian Declaration or Designation?

A "Guardian" is the person who is charged with caring for minor children. In Texas, children are minors until they reach age 18. Guardians may be named in your Will or in a separate instrument titled, "Declaration of Guardian for Minor Children." A "guardian of the person" is responsible for making parental decisions regarding the minor's upbringing, education and welfare. A "guardian of the estate" manages funds that belong to the minor (but not funds that are placed in a trust for the minor, which are managed by the trustee of the trust). The same person may be both the guardian of the minor's person and the guardian of the minor's estate. This person may, but need not, be the same person who serves as trustee of any trust created for the minor's benefit in your Will. Co-Guardians of a minor's person may be named, but only if they are married to each other (i.e., husband and wife).