Using Spousal "Bert and Earnie" Trusts to Stretch Estate Tax Exemptions

Few spouses recognize that just as you can make annual trust gifts for other family members that are excluded from federal gift and estate tax, you can also make annual tax excluded gifts to your spouse. These spousal tax excluded gifts are often an overlooked opportunity because of the ease of qualifying for the gift tax marital deduction. However, marital deduction gifts do not escape estate taxation when the donee spouse dies. For years, we have counseled clients to use inter-spousal "Bert and Earnie" Trusts to **b**uild **e**quity with **r**e**t**ained **earni**ngs outside of both their potentially estate-taxable estates using such tax-excluded gifts.

In our last article, we described how Spousal Lifetime Access Trusts ("SLATs") can be employed to preserve existing estate tax exemptions, focus appreciation on gifted assets outside their taxable estates, create protected "nest eggs" from potential creditors' claims, and, at the same time, remain available to the couple for their needs during their joint lifetime. In reality, such SLATs are also Bert and Earnie Trusts that can receive maximized regular annual tax-excluded gifts without reducing remaining estate and gift tax exemptions.

The tax-free compounding of trust values over time can be significant. As demonstrated by the table below, a limited initial $315,000 gift followed by annual $15,000 gifts for 15 years can easily grow to $963,000 over that time, all outside the donor's taxable estate. **If both spouses create such Bert and Earnie Trusts and make these gifts, the benefit is doubled to almost $2 million.**

Bert and Earnie Trust Growth

Assumptions

Initial Year Contribution: $315,000

Assumed Rate of Return on Trust Assets: 5%

(Since these are "grantor" type trusts, income taxes on trust income and growth are assumed to be paid from the donor's non-trust sources.)

Year by Year Results (per single trust)

Year	Contribution	Annual Return	End of Yr. Trust Balance
1	$315,000	$15,750	$330,750
2	$15,000	$17,288	$363,038
3	$15,000	$18,902	$396,939
4	$15,000	$20,597	$432,536
5	$15,000	$22,377	$469,913
6	$15,000	$24,246	$509,159
7	$15,000	$26,208	$550,367
8	$15,000	$28,268	$593,635
9	$15,000	$30,432	$639,067
10	$15,000	$32,703	$686,770
11	$15,000	$35,089	$736,859
12	$15,000	$37,593	$789,452
13	$15,000	$40,223	$844,674
14	$15,000	$42,984	$902,658
15	$15,000	$45,883	$963,541

These benefits will further compound dramatically if longer building periods are available during the spouses' joint lifetime.

Plan for Two Applicable Gift Tax Rules

As discussed in more detail below, when making gifts to a Bert and Earnie Trust, the donor spouse must carefully follow two rules to qualify for tax-free use of the donor's annual exclusion amount: the "present interest gift" rule and the "5 and 5 limit" rule.

The Present Interest Gift Rule

Contributions to an irrevocable trust are considered gifts to the beneficiaries of the trust and are therefore gift taxable. Ideally, the maker would like to use the $15,000 annual gift tax exclusion rather than forego a part of his or her lifetime estate and gift tax exemption to help offset any gift taxes that may arise. To

qualify gifts to an irrevocable trust for the annual gift tax exclusion, the beneficiary for whom the exclusion is sought must have a "present interest" in the amount given to the trust. A present interest is the right immediately to enjoy the amount of the gift. Under ordinary circumstances, however, the gift to a trust is not eligible for the $15,000 annual gift tax exclusion because the beneficiaries do not actually have the free use of the gift presently. The amount of the gifts would instead reduce the maker's lifetime gift tax exemption amount, or if that is insufficient, they would then be subject to gift tax.

However, a present interest can be created by giving that beneficiary the right to withdraw the gift from the trust under a provision known as a "demand right" or "withdrawal right," sometimes called a "*Crummey* power." In a famous court case in the late 1960s (*Crummey v. Commissioner*), the courts decided that if an irrevocable trust's beneficiary is given the right to withdraw a gift made to the trust for a reasonable period of time immediately after the gift is made, the beneficiary will have a present interest in the gift, and the gift will qualify for the annual gift tax exclusion. Thus, a demand right gift of up to $15,000 can be given to a beneficiary spouse each year and still qualify for the annual exclusion, regardless of whether the donee spouse actually exercises this withdrawal right.

The 5 and 5 Limit

Unfortunately, the right to withdraw assets means that the demand right beneficiary has a *power of appointment* during the time in which he or she can withdraw the assets. For annual exclusion gifts placed in trust, Section 2514(e) of the Internal Revenue Code mandates that the release or lapse of the power of appointment results in a gift by the donee of a "future interest to the other trust beneficiaries" to the extent that the released amount exceeds the greater of $5,000 or 5 percent of the sums subject to the release. This provision is commonly called the "5 and 5" limit. If the donor makes a gift to the beneficiary with a withdrawal right that exceeds this 5 and 5 limit, and even if the beneficiary does not exercise his or her right to withdraw, under Section 2514(e) that beneficiary makes a gift to future beneficiaries of the trust equal to the value of the amount given up that is over the 5 and 5 limit. The amount of this gift reduces the beneficiary's lifetime gift tax exemption amount or subjects the beneficiary to paying gift taxes. Generally, with a SLAT or Bert and Earnie Trust, our goal is to completely keep all of the trust assets free from estate tax liability upon both the donor spouse and donee spouse's death. Compliance with the 5 and 5 limit rule therefore requires that we take care that the gifts to the trust are no greater than $5,000 per year or that the gift, up to the maximum annual gifting exclusion for that year, does not exceed 5 percent of the trust assets.

Even more importantly for our purposes, if the unexercised right to withdraw assets exceeds the 5 and 5 limit, the donee spouse will be deemed to have made a gift to a trust in which he or she has retained a lifetime benefit. In this case, another provision of the Internal Revenue Code will subject the trust assets at the donee spouse's death to federal estate tax, precisely the result we are trying to avoid.

Our Recommendations

For these reasons, I recommend that each spouse make annual gifts to his or her Bert and Earnie Trust (for the benefit of the other) that are only subject to the other spouse's withdrawal right up to the 5 and 5 limit. With this the case, the value of the initial gift to the Bert and Earnie Trust becomes important since the value of the trust assets will determine which is greater, $5,000 or "5 percent of the aggregate value of the assets out of which" the gift may be completed. Since 5% of $300,000 is $15,000, $15,000 annual gifts from each spouse can be fully excluded if the SLAT/Bert and Earnie Trusts each have assets valued at $300,000 or more. The 5 and 5 limit will not be a problem if we initially gift, and thereafter

maintain, at least $300,000 of value in each trust. I recommend an initial transfer of assets with an aggregate value of at least $315,000 so that the maximum amount, $15,000 (or 5% of $300,000) can be gifted on a gift-tax excluded basis for the first year and each year thereafter.

In summary, because of the tax-free compounding available to grantor type trusts, the build-up of estate tax free assets from the initial gift and a series of such $15,000 annual gifts can build to significant amounts over the years while remaining available to the spouses as discussed in our prior article. Since these are “grantor” type trusts for income tax purposes, Bert and Earnie Trusts can even be written so that the spouses can “swap” trust assets for outside assets of equal value if they need to recover appreciated assets in the trust that will not be eligible for stepped-up capital gains treatment after the beneficiary’s death. If the creators can plan for the potential limitations and pitfalls discussed in our article on SLATs, Bert and Earnie Trusts make wonderful protected “nest eggs” from potential creditors’ claims, while, at the same time, remaining available to the couple for their needs during their joint lifetime. With future estate tax exemption amounts uncertain, they also make great hedge strategies using limited initial funds to build estate-tax exempt assets in addition to whatever exemptions may be available at the time of death. If we can help you take advantage of these opportunities, please feel free to contact us.