

Does your estate plan include a formula funding clause?

Published on May 2, 2019

The gift and estate tax exemption is higher than it's ever been, thanks to the Tax Cuts and Jobs Act ("TCJA"), which temporarily doubled the exemption to an inflation-adjusted \$10 million (\$20 million for married couples who design their estate plans properly). This year, the exemption amount is \$11.4 million (\$22.8 million for married couples).

If you're married and you executed your estate planning documents years ago, when the exemption was substantially lower, review your plan to ensure that the increased exemption doesn't trigger unintended results. It's not unusual for older estate planning documents to include a "formula funding clause," which splits assets between a credit shelter trust and the surviving spouse — either outright or in a marital trust.

Formula funding clause in action

Although the precise language may vary, a typical clause funds the credit shelter trust with "the greatest amount of property that may pass to others free of federal estate tax," with the balance going to the surviving spouse or marital trust. Generally, credit shelter trusts are designed to preserve wealth for one's children (from an existing or previous marriage), with limited benefits for the surviving spouse.

A formula clause works well when an estate is substantially larger than the exemption amount — but, if that's no longer the case, it can lead to undesirable results, including inadvertent disinheritance of one's spouse.

For example, Ciara and Mike, a married couple, each own \$10 million in assets, and their estate plan contains a formula funding clause. If Ciara died in 2017, when the estate tax exemption was \$5.49 million, that amount would have gone into a credit shelter trust and the remaining \$4.51 million would have gone to a marital trust for Mike's benefit. But if Ciara dies in 2019, when the exemption has increased to \$11.4 million, her entire estate will pass to the credit shelter trust, leaving nothing for the marital trust.

Exemption amount heading up and then down

With the TCJA temporarily doubling the gift and estate tax exemption amount, unexpected results may occur if you don't review and revise your plan accordingly. This is especially true if your plan includes a formula funding clause.

In addition, be aware that, even though the exemption amount will continue to be adjusted annually for inflation, it expires after 2025. Without further legislation, the exemption will return to an inflation-adjusted \$5 million in 2026. We'd be pleased to help review your plan and determine if changes are needed.

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