BYPASS TRUSTS

Bypass Trusts: Obsolete Bygones or Too Good to Pass Up?

Estate tax exemption portability has diminished the luster of bypass trust arrangements for many married couples, but those trusts still offer certain advantages.

Author: GLEN T. EICHELBERGER AND BRIAN P. TEAFF, ATTORNEYS

GLEN T. EICHELBERGER and BRIAN P. TEAFF are attorneys in the private client services practice of the law firm of Bracewell & Giuliani, LLP, Houston, Texas. Their practices are concentrated in the area of estate and tax planning and tax policy.

The American Taxpayer Relief Act of 2012 (ATRA) recently made permanent the increased estate tax exemption amount and the ability for a husband and wife to benefit from each other's unused estate tax exemption amount ("portability"). In response, many estate planning professionals are wondering whether estate plans involving the mandatory use of a "bypass trust" are bygones of another era. Given the benefits that bypass trusts continue to offer, however, many couples' continued reliance on bypass trust planning is as relevant as ever.

ATRA

President Obama signed ATRA into law on 1/2/2013. Among its provisions affecting the estate planning arena, ATRA made permanent a $5 million basic exclusion amount, commonly called the "estate tax exemption amount," indexed for inflation since 2011. Because of this inflation adjustment, the exemption amount has already increased to $5.25 million for 2013. This means that in 2013 a person who has made no prior taxable gifts can transfer up to $5.25 million at death without having to pay an estate tax.

In addition to the $5 million estate tax exemption amount, ATRA also made permanent the concept of "portability" under Section 2010. Portability essentially allows a husband and wife to benefit from each other's unused estate tax exemption amounts without the need for a bypass trust, which has been the predominant feature of estate plans for wealthy families for decades.

Traditional bypass trust planning

Prior to ATRA's passage, it was generally impossible for a married couple's estate plan to avoid some degree of complexity to ensure tax efficiency because a spouse's estate tax exemption amount was a "use it or lose it" proposition. The first spouse to die could transfer all of his or her property to the surviving spouse without incurring estate tax liability because of the unlimited marital deduction available for outright transfers to spouses under Section 2056.

In that event, however, the deceased spouse's estate would have no estate tax liability, so the decedent's estate tax exemption amount would, in effect, be wasted-potentially costing millions of estate tax dollars. Upon the surviving spouse's subsequent death, if all assets were to be transferred to the couple's children, 100% of the couple's property would be included in the surviving spouse's taxable estate, with the resulting estate tax liability offset by only the surviving spouse's own estate tax exemption amount.

Example 1. Husband and Wife each have a gross estate of $5.25 million (or, together they own $10.5 million of community property in a community property jurisdiction). Neither husband nor wife has ever made an estate tax taxable gift. Husband dies in 2013 survived by Wife. Husband's last will provides "If my wife survives me, I give to her all of my property, outright and free of trust." Wife dies later in 2013.

Without the portability provisions under ATRA, upon Wife's death, her gross estate of $10.5 million (her $5.25 million of assets plus the $5.25 million she inherited from Husband) would be subject to estate tax liability (assuming no complicated post-mortem estate planning occurs, such as a qualified disclaimer). Unfortunately, because Husband's unused estate tax exemption was not preserved, only Wife's $5.25 million estate tax exemption amount would be available to reduce the resulting tax.

To protect against the waste of the predeceased spouse's estate tax exemption amount, estate plans designed to reduce estate tax liability generally included "bypass trusts" (commonly referred to as "family trusts") to be funded with assets equal to the predeceased spouse's estate tax exemption amount available at his or her death. The surviving spouse could be a beneficiary of the bypass trust and potentially even manage the trust assets by serving as its trustee. If the bypass trust is properly drafted, the value of the trust's assets would not be included in the surviving spouse's gross estate on his or her death because the bypass trust owns the assets-not the surviving spouse.

Example 2. The facts are the same as in Example 1, except that Husband's last will provides "I give to the trustee of the bypass trust under my last will such an amount of property as is equal to my unused estate tax exemption amount." Upon husband's death, his $5.25 million available estate tax exemption amount is funded into the bypass trust under his last will. Upon wife's subsequent death, her gross estate will only be $5.25 million because the bypass trust owns the $5.25 million previously owned by husband. Thus, wife's available $5.25 million estate tax exemption amount will entirely offset the resulting tax liability, meaning that no estate tax will be due.

Now that portability has been made permanent under ATRA, the need for bypass trust planning is no longer mandatory to preserve the deceased spouse's unused estate tax exemption amount.

Example 3. The facts are the same as in Example 1, except portability applies. Assuming the personal representative of Husband's estate elected to permit Wife to use Husband's unused estate tax exemption amount by filing Form 706, U.S. Estate (and Generation-Skipping Transfer) Tax Return, Wife's estate would be able to use Wife's $5.25 million estate tax exemption amount plus Husband's $5.25 million unused estate exemption amount, effectively giving Wife a $10.5 million estate tax exemption amount. No estate tax will be due because Wife's $10.5 million exemption amount entirely offsets her $10.5 million gross estate.

Down, but not out

As Examples 2 and 3, above, illustrate, portability can have the same effect as the use of a bypass trust in preserving the predeceased spouse's estate tax exemption amount to reduce or even eliminate estate tax liability on the surviving spouse's death Instead of automatically including bypass trust planning for couples with moderate to high levels of wealth, which had been the case for years, couples are now considering the pros and cons of relying on portability versus the merits of creating a bypass trust at the death of the first spouse.

Among the pros of the continued use of bypass trust planning are the following:

- Assets in a bypass trust can appreciate in value outside of the surviving spouse's estate, regardless of the extent of the appreciation. Conversely, property passing to a surviving spouse under a portability-based plan will appreciate in value within the surviving spouse's estate, meaning that the appreciation will be subject to the estate tax on the surviving spouse's death. Moreover, the amount of the deceased spouse's unused estate tax exemption is determined in the year of his death, and is not subsequently adjusted for inflation. As a result, a bypass trust may be an ideal parking spot for assets that are likely to significantly appreciate in value. For example, bypass trust planning may be appropriate if a couple's assets include ownership interests in startup companies, mineral interests in and around proven plays, and real estate in geographic areas where an explosion in value is anticipated.
- Assets of a bypass trust are generally protected from the surviving spouse's future creditors. In addition, should the surviving spouse remarry, a properly drafted spendthrift provision would protect the bypass trust assets from the new spouse's creditors. As a result of the $5 million estate tax exemption amount, the creditor protection feature of bypass trusts is even more beneficial than ever due to the substantial amount of property that can be funded into a bypass trust and protected from the surviving spouse's creditors.
- By forcing the creation of a bypass trust, the deceased spouse can protect against the surviving spouse "redirecting" the assets to a person that the deceased spouse may not wish to benefit. For example, if the family is a blended family such that the spouses have different ultimate

remainder beneficiaries (i.e., each spouse's children by a first marriage), a bypass trust may be required to preserve both family harmony and the value for the individual's intended beneficiaries at the death of the second spouse.

- Because portability is available with respect to the estate tax exemption amount of only the "last deceased spouse," the deceased spouse's ported estate tax exemption amount may be lost in the event of the surviving spouse's remarriage. This could be particularly problematic if the surviving spouse remarries a wealthy individual who also predeceases the surviving spouse and does not have any estate tax exemption amount available for portability.
- A decedent's personal representative has to take action to file an estate tax return to permit the surviving spouse to use the decedent's unused estate tax exemption amount. Accordingly, couples with small gross estates who rely on portability must file an estate tax return even though no estate tax is actually due. Conversely, the use of a bypass trust could potentially eliminate the need for filing this return.
- For a married couple with significant wealth, trust planning is still necessary to achieve generation-skipping transfer (GST) tax efficiency because the GST exemption is not portable under ATRA. Planning to preserve 100% of the available GST exemption is important to the long-term planning for the couple's descendants. Over the long term, the proper use of both spouse's GST exemption can prove to be one of the most valuable long-term features of an estate plan for a wealthy family. Although a wealthy couple may wish to avoid complexity, they will surely appreciate the value of avoiding estate taxes for multiple generations.

Notwithstanding the list of benefits of bypass trusts, among the advantages of relying on portability are the following:

- Most assets included in the surviving spouse's estate will receive a second step-up in basis for federal income tax purposes on such surviving spouse's death (the first step-up occurred on the death of the first spouse). Conversely, assets funded into a bypass trust receive a step-up in basis only on the death of the first spouse. Because the estate tax rate will almost always be greater than the capital gains rate, however, the advantage of the additional step-up must be weighed against the estate tax liability that occurs as a result of the assets being included in the surviving spouse's estate.
- Assets can be sheltered in a retirement account from estate tax liability without having to include complex provisions in the decedent's last will to qualify the bypass trust as an acceptable designated beneficiary. Portability offers to greatly simplify this issue because the surviving spouse can easily be named as the designated beneficiary of such accounts and receive the benefits, without the need for complicated trust provisions.
- Bypass trusts introduce additional administrative complications to the surviving spouse who generally prefers to maintain "business as usual." For example, bypass trusts require the filing of annual tax returns and trust accountings, which the surviving spouse may wish to avoid.

Conclusion

Undoubtedly, literally millions of estate plans contain bypass trust planning to protect against wasting the predeceased spouse's estate tax exemption amount. However, many married couples who once needed "mandatory" bypass trust planning may no longer need such complexity because of portability and the $5 million estate tax exemption amount (growing each year by inflation). Despite the attractiveness of a portability-based estate plan, while the *automatic* inclusion of bypass trust planning may be a bygone, bypass trusts continue to offer significant benefits as described above, even if created as a result of the surviving spouse's election to make a qualified disclaimer in an estate plan that includes a disclaimer trust.

For many couples seeking to take advantage of both estate tax and GST tax planning, bypass trusts will continue to be an important feature of their testamentary planning unless GST exemption has been consumed during lifetime. As a result, it may be premature to declare that portability has rendered bypass trusts obsolete.