Estate Planning Insights

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Bypass Trust Versus Portability–Part 1

Tax Numbers for 2016. Many tax exemption amounts are adjusted annually for inflation. Due to the recent low inflation rate, however, some exemption amounts stayed the same and some barely changed. Here are *some* of the relevant 2016 tax numbers:

Estate/Gift/GST Exemption Amount: $5,450,000 (up $20,000 from last year--this exemption is $5 million, adjusted for inflation each year, with the base year being 2011)

Annual Gift Tax Exclusion Amount: $14,000 (no change from last year)

Annual Exclusion Amount for Gifts to Spouses who are *not* US Citizens: $148,000

The "highest" (basically, the "effective") estate/gift/GST tax rate: 40% (no change)

"Complex trusts" (non grantor trusts that contain a discretionary income distribution standard) reach the highest income tax rate, i.e., 39.6%, once they have annual income over $12,400. Complex trusts are also subject to the "net investment tax" of 3.8%. Single individuals do not reach the 39.6% tax bracket until they have $415,050 in annual income and married couples filing jointly do not reach the 39.6% bracket until they have $466,950 in annual income. Thus, except in the case of a complex trust having a sole current beneficiary who is being sued or who is also in the highest income tax bracket (or who already has a taxable estate), it might be better to distribute the trust's "ordinary income" (interest, dividends, rent, etc.) out of the trust to a permissible beneficiary for a permissible purpose.

Direct IRA Rollover To Charity Made Permanent. Pursuant to the Protecting Americans from Tax Hikes (PATH) Act, signed into law on December 18, 2015, Congress made permanent the provision allowing IRA owners age 70½ and older to direct a distribution from their IRA to charity in amounts not exceeding $100,000 per year. This provision has been "in and out" of the law for many years. Now it is permanent (well, at least as "permanent" as you can get with anything done by Congress). The amounts directed to charity from the IRA are not included in the IRA owner's income. Note that the IRA owner does not get an income tax charitable deduction either (since the distribution is not included in his income). However, the amount distributed to charity directly from the IRA counts toward the IRA owner's "minimum required distribution" for the year (up to the $100,000 limit). As was the case with prior versions of the direct rollover provision, distributions from IRAs can only be made to public charities and NOT to donor-advised funds, supporting organizations, split-interest charitable trusts or private foundations. Still, it is a great way for IRA owners age 70½ or older to make distributions to their favorite charities each year with "pre-tax" funds.

Bypass Trust Versus Portability. With the passage of the American Taxpayer Relief Act of 2012 (ATRA) in January 2013, estate planners began debating which married couples should create a Bypass Trust and which married couples should simply leave everything directly to the surviving spouse and, if necessary, make the portability election. Ignoring non-tax reasons for creating a trust, married couples whose combined net worth is far below $5,450,000 do not need a trust for tax reasons. However, married couples with a combined net worth at or above $5,450,000, really do have to consider estate taxes when doing estate planning. For those couples, there are pros and cons of these two approaches, i.e., creating and funding a Bypass

Trust versus leaving everything outright to the surviving spouse and making the portability election. In this newsletter, we will start the discussion, but focus solely on couples in traditional marriages. In a second marriage, where each spouse has a child or children from a prior marriage, there are other considerations besides estate taxes that must be taken into account. We will discuss second marriage situations in Part 2 of this series.

First Step: Calculate Your Net Worth. First, do you know the size of your estate for federal estate tax purposes? You should list *all* of your assets and the "fair market value" of each in a net worth statement that you update at least once a year. That way, you will know whether you have a "taxable estate" or not. Remember that, for federal estate tax purposes, your estate includes your interest in all assets, worldwide. In terms of the types of assets to consider, your estate includes your ownership interest in real estate, stocks, bonds, mutual funds, other kinds of investments, bank and other cash accounts, life insurance (if the *insured* is you or your spouse, use the death benefit, or proceeds, as the estate tax value), annuities, retirement plans, including qualified and non-qualified employee benefit plans and IRAs, tangible personal property (such as household furnishings and personal effects, including furniture, art, jewelry, china, silver, etc.), vehicles of all types, royalties and other mineral interests, business interests (including interests in corporations, partnerships and LLCs), etc.

Also remember that Texas is a community property state. In the case of married couples, on the death of the first spouse (who we will call the "Deceased Spouse"), all assets on hand are *presumed* to be community property. It is difficult to overcome the community property presumption (unless the couple has a Pre-Marital or Post-Marital Agreement). In fact, nearly all assets accumulated by a married couple while living in Texas are going to be community property, which is not necessarily a bad thing from a tax standpoint. Because each spouse owns ½ of the community property, that helps each spouse utilize his/her own estate tax exemption amount. Plus, both halves of the community property assets obtain a "step up" in income tax basis on the Deceased Spouse's death. In view of typical estate planning that is done, that is almost always a *tax-free* "step up" in income tax basis. Thus, a married person's estate includes his/her ½ of the community property plus his/her separate property, if any. However, when advising a couple in a traditional marriage, we look at the couple's combined estate or combined net worth. Once we know the value of the combined estate, we know whether that couple needs to "do something" to avoid paying federal estate taxes.

VERY IMPORTANT: There is a widely held misconception regarding how the estate tax exemption actually works, so here is the point we want to make: Married couples do not *automatically* get 2 exemptions from the federal estate tax. That has always been the case and that rule did not change with the passage of ATRA in January 2013. Married couples must *do something* in order to get 2 exemptions from the federal estate tax. In other words, there is no automatic "couple exemption" equal to 2 times the estate tax exemption amount. To say it yet another way, *without appropriate action*, upon the death of the spouse who dies second (who we will call the "Surviving Spouse"), estate taxes will be payable on everything above the $5 million exemption amount, as adjusted for inflation, at a rate of 40%. Thus, if a married couple desires to shelter from federal estate taxes 2 times the exemption amount, or $10,900,000 under current law, they must do something more than create a simple estate plan. If a married couple does not "do the right thing," they will end up "wasting" the $5,450,000 estate tax exemption amount of the Deceased Spouse, which often leads to the payment of "unnecessary" (otherwise avoidable) estate taxes on the death of the Surviving Spouse.

Three Choices. There are actually three (3) "typical" choices for making sure that both spouses' exemptions are used (i.e., not wasted): (i) create and fund a "Bypass Trust" on the Deceased Spouse's death, (ii) make the "portability election" on the Deceased Spouse's death, and (iii) leave the Deceased Spouse's estate tax exemption amount directly to his children (i.e., skip the Surviving Spouse completely). Only the first two (2) of these choices are used with any frequency by couples in traditional marriages. In this newsletter, we are going to discuss, in some detail, the first choice–create and fund a Bypass Trust on the Deceased Spouse's death. In Part 2 of this series, we will discuss the portability election, and will add some considerations for couples in second marriages. We also plan to include a summary chart in Part 2.

Bypass Trust Approach. A married couple can create an estate plan, either in their Wills or in a Revocable (Living) Trust (hereafter, both documents referred to as a "Will"), in which a "Bypass Trust" (also known as a "Credit Shelter Trust" and sometimes called a "Family Trust") is created on the Deceased Spouse's death. The Bypass Trust is for the primary benefit of the Surviving Spouse during her life. If the Surviving Spouse is serving as the sole Trustee of the Bypass Trust, distributions can be made from the trust to her, or for her benefit, for purposes of her health, support and maintenance, to maintain her accustomed standard of living. "Health" is a very broad term and fairly well understood. "Support and maintenance" refers to all of the necessities of life, such as food, clothing, shelter, transportation, etc. If an "Independent Trustee" (such as a bank or private trust company) is serving as Trustee of the Bypass Trust, distributions can be made to or for the benefit of the Surviving Spouse for purposes beyond health, support and maintenance, such as happiness, comfort and welfare.

Bypass Trusts for couples in traditional marriages are often drafted to allow distributions to be made to the couple's children and grandchildren during the Surviving Spouse's life also, with "education" being included as an additional, permissible purpose for making distributions from the trust.

The assets in the Bypass Trust are protected from "creditors' claims," such as a tort creditor who sues the Surviving Spouse for personal injuries sustained in a car accident. The Bypass Trust assets are also protected from the new spouse of the Surviving Spouse. That new spouse is not a beneficiary of the trust while the Surviving Spouse is living and cannot receive the Bypass Trust assets on the Surviving Spouse's death. Instead, when the Surviving Spouse dies, the assets remaining in the Bypass Trust will be distributed to the couple's children (or to "lifetime, protective trusts" for them, usually called "Descendant's Trusts").

The assets held in the Bypass Trust when the Surviving Spouse dies are not included in the Surviving Spouse's estate for federal estate tax purposes. In that way, the Bypass Trust assets "bypass" federal estate taxes. Assuming that the Bypass Trust was "fully funded" on the Deceased Spouse's death (i.e., assets having a total value equal to the Deceased Spouse's estate tax exemption amount were placed in the Bypass Trust when he died), when the Surviving Spouse dies, the Deceased Spouse's exemption amount (plus all appreciation in value after his death) will be distributed to the couple's children (or to their Descendant's Trusts), free of estate taxes. In addition, assets owned by the Surviving Spouse equal to her estate tax exemption amount will be distributed to the children, free of estate taxes, when she dies. In this way, the couple can transfer 2 x the exemption amount to their children, estate tax-free.

It is not sufficient simply to include provisions creating a Bypass Trust in the couple's Wills. The Bypass Trust must be *set up* and *funded* on the Deceased Spouse's death. That means that the Deceased Spouse's ownership interest in the assets must be "distributed" pursuant to his Will and re-titled into the name of the Bypass Trust (and under the Bypass Trust's taxpayer identification number). This re-titling of the assets into the name of the trust is called "funding" the trust. WARNING: If accounts and other assets pass directly to the Surviving Spouse on the death of the Deceased Spouse, those accounts and assets will NOT end up in the Bypass Trust–they will end up being owned, individually, by the Surviving Spouse. The Surviving Spouse CANNOT place assets that she owns into the Bypass Trust–that doesn't work for estate tax purposes. Thus, when accounts and other assets pass directly to the Surviving Spouse on the death of the Deceased Spouse, this often prevents the Bypass Trust from being fully funded when the Deceased Spouse dies and can defeat the purpose of planning for a Bypass Trust. Thus, excluding a modest joint checking account--which can pass directly to the Surviving Spouse without destroying the couple's entire estate plan--couples who use the Bypass Trust approach should make sure that none of their sizeable joint accounts are titled as "Joint Tenants with Right of Survivorship" (a/k/a "JTWROS" and "JT TEN") or as a "Multi-Party Account with Right of Survivorship," and that none of their individual, non-IRA accounts are set up with a "Pay on Death" ("POD") or a "Transfer on Death" ("TOD") arrangement, naming the Surviving Spouse as the direct beneficiary. None of the assets subject to JTWROS, POD and TOD arrangements in favor of the Surviving Spouse "will make it into" the Bypass Trust when the Deceased Spouse dies. And, yes, it is *sometimes* possible for the Surviving Spouse to

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"disclaim" accounts and other assets passing directly to her on the Deceased Spouse's death, to cause the Deceased Spouse's interest in the disclaimed accounts/assets to go back into his estate, to be distributed pursuant to his Will to the Bypass Trust. However, by the time this error is discovered, it is often too late for the Surviving Spouse to make a "qualified disclaimer," which is the only type of disclaimer that makes sense in this situation. Thus, it is not only necessary to create a Bypass Trust in both spouse's Wills, the assets that will fund the Bypass Trust must go through the Deceased Spouse's Will when he dies in order to "make it into" the Bypass Trust. Again, JTWROS, POD and TOD arrangements prevent that. Those arrangements are heavily promoted because they "avoid probate." However, there are worse things than going through probate, such as paying millions of dollars to the IRS in "unnecessary" estate taxes when the Surviving Spouse dies. For more detail on this, *see* our prior newsletters.

Incidentally, one of the advantages of placing the couple's estate plan in a Revocable (Living) Trust, instead of in Wills, is the ability to title accounts and other assets in the name of the Trust.

Stay Tuned For Part 2! We will discuss the portability election next time and compare that option to using a Bypass Trust.

Time For a Check Up? If (i) you are in a traditional marriage, (ii) your Wills were executed prior to January 2013, (iii) your Wills contain a Bypass Trust, and (iv) your combined estate is well below $5 million, you should come in for a check up. You may be able to switch to "simple Wills." And, regardless of your marital status or net worth, if your estate plan has not been reviewed in over 7 years, it's time for an estate planning check up!

Contact us:

If you have any questions about the material in this publication, or if we can be of assistance to you or someone you know regarding estate planning or probate matters, feel free to contact us by phone, fax or traditional mail at the address and phone number shown above, or by email sent to:

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