



DETOUR AHEAD?

WHY YOUR CLIENTS STILL NEED A BYPASS TRUST

The bypass trust has long been a standard tool in the arsenal of estate planners as a means of protecting the unified credit or estate tax exclusion amount of the first spouse to die. Without the bypass trust, most assets would pass to the surviving spouse and be subject to estate tax at the survivor's death, with only his or her exclusion amount then available. But with the 2010 Tax Relief Act (officially the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 signed into law by President Obama on December 17, 2010), two significant tax changes were introduced that caused planners to question the continued viability of the bypass trust. First, the estate tax exclusion amount was increased to \$5 million; and second, if a deceased spouse does not use all of his or her estate tax exclusion, it can now be carried over to the surviving spouse.

At first glance, this carryover of unused exclusion (often referred to as "portability") appears deceptively simple – use only what you need at the first death and your spouse can use the rest later. As a result, many couples who already have an estate plan that incorporates a bypass trust and whose combined estates are less than \$10 million may well be asking their advisors whether they still need one. For the reasons discussed here, however, portability should be a last resort, beneficial primarily to those clients who fail to plan at all. The bypass trust, meanwhile, continues to be an efficient tool for achieving multiple tax and non-tax objectives.

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TAX ISSUES REMAIN

The tax considerations for creating a bypass trust remain important discussion points in any planning conversation. The 2010 Tax Relief Act is only a temporary fix, with its provisions expiring at the end of 2012. There is no guarantee that the exclusion amount will remain at \$5 million, or that the concept of portability will be extended beyond 2012, although many planners are predicting that portability will become a permanent fixture in the estate planning landscape.

Relying on portability raises additional concerns beyond its limited shelf life. As currently enacted, the surviving spouse can only use the ported exemption if he or she also dies in 2011 or 2012. In addition, the exemption can be protected for the surviving spouse only if an estate tax return is filed at the first death, which may otherwise be unnecessary for estates below the filing threshold. Alternatively, utilizing a bypass trust ensures that the amount funded at the first death, and any growth on that amount, will not be included in the taxable estate of the surviving spouse. And if the exclusion is scaled back to \$2 million, for example, the funding of the bypass trust provides a significant tax savings.

In addition, many individual states have an estate tax separate from the federal estate tax, and the state exclusion amount frequently does not mirror the federal exclusion amount. Take for example, Illinois, which has an exemption of only \$2 million. Clients whose combined wealth exceeds twice that amount can fund a bypass trust at the first death with the state-level exemption amount, protecting it from the state estate tax at the second death.

A bypass trust also can be an excellent vehicle to fund with discounted assets to leverage the use of the estate tax exclusion amount. A bypass trust funded with limited partnership interests having a discounted value of \$5 million could represent an equivalent value in the underlying partnership assets of over \$7 million, assuming a 30% discount. Clients should understand the advantages of Generation Skipping Tax (GST) planning and the need to preserve the GST exemption of the first spouse with a bypass trust since the GST exemption amount is not portable like the estate tax exclusion amount. If the GST exemption is not preserved at the first death then it is forever lost.

NON-TAX REASONS TO CONSIDER A BYPASS TRUST

While there has been a general trend toward utilizing trusts as primarily tax planning devices, the origin of the trust concept was to provide a structure for beneficiaries whom the settlor had a legal or moral obligation to support. Those core purposes in establishing a trust – to protect the beneficiaries and the family wealth – remain valid considerations today and should be part of any client conversation regarding estate planning.

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PROTECTION OF FAMILY WEALTH

In response to an increasingly litigious society, clients are now keenly focused on asset protection issues relative to their general estate plan. Whereas in the past only individuals engaged in high-risk professions, such as physicians or business owners, worried about liability, today many clients express some level of concern about their exposure to lawsuits and the exposure of their family members. The recent economic difficulty has only intensified this concern. Consequently, when designing estate plans, clients should be reminded that assets transferred outright to a beneficiary will be exposed to these claims, while assets held in trust generally are protected from the claims of a beneficiary's creditors by virtue of a spendthrift provision, with some limited exceptions. A bypass trust, when drafted with an intent to provide asset protection, and then properly administered to ensure that family wealth is not commingled with a beneficiary's marital assets or otherwise subjected to creditor claims, can ensure the preservation of the assets for many generations.

Many clients will attempt to address their own asset protection planning during life by holding assets as tenants by the entirety with a spouse, which in many jurisdictions will protect the assets from the creditor claims of either spouse. While perfecting the entireties ownership can sometimes be challenging, the real challenge occurs at the death of one spouse when the entireties is lost. Those clients in certain circumstances can maintain partial protection of the assets at the first death by having the surviving spouse execute a disclaimer of a one-half interest in the entireties property or the portion of an entireties bank or brokerage account consisting of contributions from the decedent (authorized in many states). The disclaimed interest can then pass through the estate and fund a testamentary bypass trust. The surviving spouse can be a significant beneficiary of income and principal of the bypass trust, despite the prior disclaimer.

If remarriage of the surviving spouse is a concern, a bypass trust can lock in the beneficiary selection and protect against diversion of assets to a new spouse and stepchildren. The same concept holds true to protect against the efforts of a financially abusive family member, a caregiver or anyone else who might exercise undue influence over the spouse in an attempt to control their assets. The surviving spouse may or may not be given the limited ability to change eventual distribution among a class of identified beneficiaries with a power of appointment. Although the surviving spouse as beneficiary is a convenient example, any beneficiary's interest can be better protected in the event of marriage, divorce or remarriage while their interest is held in trust.

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TAILORED DISTRIBUTION STANDARDS

An outright transfer of assets provides the recipient unfettered access to and use of the funds, which may not always be desirable or prudent. Carefully structured bypass trust provisions can provide as much or as little access to the assets as the settlor directs. An independent trustee also can be designated and authorized to provide broad access to the funds based on very generous discretionary standards, even to the point of exhaustion, as may be in the best interest of the beneficiaries.

Advisors should carefully review with clients the directions for distributions, to assist the client in identifying and memorializing their personal family goals. If beneficiaries of a bypass trust will include the spouse as well as children and later generations (often referred to as a “spray” trust), it will be important to state priorities in the trust to avoid conflicts among beneficiaries and provide adequate direction to the trustee as to whose interests take priority over the others. The client should also direct whether distributions will be treated as an advance against a beneficiary’s future interest. Some clients feel strongly that distributions to children should always be equal, regardless of their individual needs, to maintain family harmony, while others prefer that children with greater needs receive greater distributions.

In the case of a second spouse who is not the parent of the remainder beneficiaries, it is extremely important that the trust agreement address explicitly whether the client’s intent is to favor the interests of the surviving spouse over those of the children or more remote descendants. The needs and priority of the surviving spouse should be made particularly clear in the trust document. For example, a surviving spouse may not be pleased to learn that a grandchild’s tuition payments will deplete the discretionary income that she had grown accustomed to receiving. In many cases, clients prefer that the surviving spouse automatically receive all income, or even a set unitrust payment, and that any discretionary distributions be made only from principal.

Lastly, clients should carefully consider whether inclusion of multiple generations of beneficiaries is desired when all currently permissible beneficiaries must receive statements of account at least annually. Many clients do not want to share the extent of the family wealth beyond the next immediate generation for fear it will encourage financial dependence.

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FINANCIAL MANAGEMENT

Many beneficiaries lack investment management experience and need assistance with financial planning, budgeting and bill paying. Indeed, protecting a spendthrift beneficiary is an overriding concern for many clients. Oftentimes those concerns drive a distribution pattern that is limited to income only, or a unitrust-type payment, with principal invasion rights limited to extraordinary or emergency needs such as medical expenses.

Provisions that authorize the trustee to apply funds in the bypass trust for the education of grandchildren, for instance, can ensure that those grandchildren have the opportunity to attend college or graduate school even if their parents cannot afford this often significant expense. Moreover, the designation of a trustee or co-trustee with investment expertise and knowledge of the prudent investor rule can be essential both to supporting the non-investment goals of the estate plan and to ensuring that the funding of those goals is addressed in the investment model. This independent trustee or co-trustee also can provide critical objectivity for those beneficiaries who are inexperienced investors or even spendthrifts.

NOT A SOLUTION FOR EVERYONE

Despite the strong tax and non-tax benefits for utilizing a bypass trust, it may not be the appropriate choice for all clients. Clients whose primary source for funding a bypass trust is either real estate, an IRA or other retirement plan, may be better served with beneficiary designations or forms of joint ownership that ensure the asset passes to the intended beneficiary in the most efficient manner. An IRA, for example, is a depleting asset due to the required minimum distributions and the income taxes that accrue with each distribution. And if the beneficiary designation and trust provisions are not carefully coordinated, the beneficiary could lose significant income tax benefits with an accelerated payout that is not based on their life expectancy.

Real estate, too, offers challenges as it is frequently an illiquid asset that requires regular expenditures for maintenance, taxes and insurance. The client should be advised to provide sufficient other liquid assets when funding the bypass trust to cover the anticipated expenditures. The more difficult situation arises when the real estate must be sold to provide for the financial needs of the beneficiary, particularly in difficult market conditions.

Some clients also perceive a bypass trust to be too complicated and/or unduly restrictive. A bypass trust does require a separate income tax return each year. The trustee must follow fiduciary investment principles, and there are typically restrictions on distributions. Assets in a bypass trust are not eligible for a stepped up basis at the surviving spouse's death, which can result in significant capital gains tax (although likely still less than the applicable estate tax). However, these concerns can be rather easily addressed with proper drafting and are far outweighed by the additional benefits offered through these vehicles.

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BUILT-IN ESCAPE CLAUSE

For the client who still is not quite convinced that the bypass trust will provide benefits to the family estate plan or who thinks the estate tax may disappear completely, an independent trustee or a trust protector can be given the discretionary authority to terminate the bypass trust at any time. This may be particularly helpful where the surviving spouse's assets combined with the bypass trust assets will be insufficient to cause a taxable estate but a stepped-up basis for the bypass trust assets would be desirable. Clear direction should be provided to the trustee or trust protector as to the factors to be considered and the distribution of the trust in the event of termination. However, this feature would not work well in the context of a spray trust as it would be nearly impossible to balance the competing interests of all of the beneficiaries in a way that would support the termination.

Each client's situation must be reviewed with an eye toward their personal and family considerations and goals, and then coordinated in a tax efficient way. The increase in the estate tax exclusion amount and its transferability between spouses does not obviate the need for good estate planning that focuses the client's attention on what is truly important to them – their family.

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