SHOULD YOU (OR YOUR CLIENT) TERMINATE THE BYPASS TRUST?

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The Bypass Trust (sometimes referred to as a "Credit Shelter Trust") is a common estate planning tool. Its primary purpose is to allow for assets within the trust to pass free of estate tax at the death of the trust beneficiary (usually a spouse or domestic partner).

Assets within a Bypass Trust, however, do not receive a "step-up" in income tax basis upon the beneficiary's death. Given that capital gains are currently taxed at a rate of 15% (for federal tax purposes) and that the highest marginal estate tax rate is 45%, the use of a Bypass Trust can still provide a significant overall tax benefit despite the loss of the step-up in basis. For example, if an asset received from a Bypass Trust is sold, the remainder beneficiaries are subject only to capital gains tax, at the 15% federal rate; the Bypass Trust assets are not subject to estate tax. So, effectively, these beneficiaries retain the 30% difference between the two taxes. Nevertheless, in circumstances where the beneficiary of the bypass trust does not have a taxable estate, the opportunity for tax savings can sometimes be lost and, indeed, the use of a Bypass Trust may result in the imposition of income tax that might otherwise be avoided.

Recently we met with new clients because their father, the surviving spouse, had passed away. When their mother died several years earlier, the Applicable Credit (then known as the "Unified Credit") sheltered only $650,000 of her estate from estate taxes. At the time of mom's death, the family trust held a residence valued at $350,000 and securities of approximately $750,000. Since all assets were owned jointly, only $550,000 could be transferred to the Bypass Trust; the remaining $550,000 was transferred to the Survivor's Trust.

The assets chosen to be placed in the Bypass Trust were the residence (FMV: $350,000) and securities valued at $200,000. The remaining assets ($550,000 of securities) were placed in the Survivor's Trust.

The reasons for funding in this manner were sound at the time: The residence, which was in a highly desired neighborhood, was likely to appreciate greatly in value while the securities were likely to be spent for father's care. In addition, the residence was not mortgaged and dad was not likely to sell and move from the property (so neither the mortgage interest deduction or the IRC Section 121 exclusion of up to $250,000 in gain did not seem of concern). Therefore, the law firm that assisted with the administration of mom's estate advised the family that the capital gains tax paid on any subsequent sale of the property would be less than the estate taxes that would be incurred if the property was subjected to estate taxes at dad's death (remember, the highest marginal estate tax rate was then 55% rather than the current 45%).

Prior to the enactment of the 2001 tax act, this planning made very good sense. In the interim between mom's death and that of dad's, however, the Applicable Credit was increased to shelter $2

million from estate taxes.

At dad's death, as predicted, the securities in the survivor's trust had, for the most part, been used for dad's care. The assets of the Bypass Trust had increased to $1.6 million in value (remember, the income tax basis was only $550,000). The bulk of this gain is attributable to a *$900,000* increase in the value of the residence). When this property is sold, between State and Federal income taxes, $225,000 in taxes will be paid. Additional capital gains will be due when the securities within the Bypass Trust are sold.

What, if anything, could have been done differently? In this case, the trustee could have sought to terminate the Bypass Trust and distribute its assets to the Survivor's Trust. Although the Bypass Trust is irrevocable, California Probate Code Section 15403 allows for the termination of an otherwise irrevocable trust if all of the beneficiaries consent. While the Probate Court must approve of any such termination, termination is generally allowed if it can be shown to the court's satisfaction that the continuance of the trust no longer serves the purpose for which it was intended. If a Bypass Trust is used to ensure that certain property will not be subjected to estate tax upon the death of the trust's beneficiary, that purpose is no longer served if including the property in the beneficiary's estate would not cause an estate tax to be due.

Termination of a Bypass Trust is probably appropriate in only limited situations. If the remainder beneficiaries of the Bypass Trust differ from those of the Survivor's Trust, termination is likely inappropriate. Such a situation might arise if either spouse has children from a prior relationship -- a significant non-tax benefit of a Bypass Trust is the guarantee that one's share of the estate (or at least a portion of it) will pass as directed within the trust document.

Careful analysis is necessary in making the decision whether or not to terminate a Bypass Trust. As a part of that analysis, one must also keep in mind the temporary (and changing) nature of our current tax laws. While the amount sheltered by the Applicable Credit is currently $2 million (which amount is scheduled to increase to $3.5 million in 2009 and to an unlimited amount as a result of the one-year repeal of estate tax in 2010), the amount sheltered by the Applicable Credit is scheduled to revert to only $1 million on January 1, 2011.

Should A Bypass Trust Automatically Be Part Of One's Estate Planning?

The question of whether or not a Bypass Trust should even be incorporated as a part of one's estate planning involves the same analysis used when determining whether or not to terminate an already-established Bypass Trust.

For example, assume the following: Michael and Isabel have been married for 42 years. Their combined net worth is $1.9 million, with each of them owning one-half of this value as his/her share of the community property. They have three mutual children. Their primary concern is to be sure that the survivor of them is provided for after one of them passes on.

Assuming no increase in the value of their estate, if both Michael and Isabel die before 2011, no estate taxes will be due. That being the case, it may be appropriate to leave everything to the Survivor's Trust, over which the survivor has a power to amend or revoke. This way, the entire estate (excluding any IRD assets) will receive a step-up in income tax basis at the survivor's death.

If, however, either Michael or Isabel passes on in 2011 when the amount sheltered by the Applicable Credit is reduced to only $1 million (or after that year if the estate tax laws are not changed prior to that time), leaving everything to the survivor of them will cause the survivor to have a taxable estate.

Given the uncertainty of the tax laws, it may be best for the survivor of Michael and Isabel to retain the ability to disclaim some or all of the other's share of the estate in order to fund a Bypass Trust if doing so appears prudent at the first death.

While allowing a choice to a surviving spouse may be appropriate in some circumstances, it is not the correct choice for all. For example, if only two of Michael and Isabel's children are mutual and the third child was from a previous relationship that Michael had before he and Isabel were married, he may wish to ensure that Isabel not favor her two children over Michael's child from the prior relationship. Similarly, Isabel wants her share of the estate to pass to her two children (not to Michael's other child). In such a circumstance, the use of a Bypass Trust will ensure both Michael and Isabel that their respective shares of the estate will be distributed as they wish. Any income tax consequences are likely secondary in such a situation.

As shown by these scenarios, sound estate planning includes analysis of the pros and cons of creating a Bypass Trust.

If you have any questions regarding the Bypass Trust or other Estate Planning matters, please call us at (619) 239-7777 or RobertaRepasy@mmpph.com.