



Should You Create A Bypass Trust In View of the Portability Provisions of the 2010 Tax Law?

The 2010 Tax Act law provides for “portability” of a deceased spouse’s unused estate tax exemption to a surviving spouse (limited, in general, to \$5,000,000). This means that, for example, if the first spouse to die does not use all of his or her exemption (because the estate is not as large as the exemption), the “unused” portion of that spouse’s exemption can be used by the surviving spouse to protect against both gift taxes and estate taxes. In order to take advantage of the portability provisions, the Executor of the predeceased spouse must file a federal estate tax return and elect to transfer the unused exemption to the surviving spouse. As discussed below, the ability to transfer a predeceased spouse’s unused exemption may allow some people to adopt a simpler estate plan, while still taking advantage of both spouses’ transfer tax exemptions.

Even though the new law allows portability of a deceased spouse’s unused exemption, **setting up a Bypass Trust when the first spouse dies might still make sense for several reasons**, which may or may not apply in a particular case:

1. There may be non-tax reasons, including:
 - (a) Limiting or eliminating the ability of the surviving spouse to direct the disposition of the deceased spouse’s assets on the surviving spouse’s death,
 - (b) Limiting the right of the surviving spouse to spend principal so that it is preserved for only the surviving spouse’s health, support and maintenance, and
 - (c) Providing creditor protection. (The surviving spouse’s creditors cannot, in general, reach the assets of the Bypass Trust.)
2. If the Bypass Trust assets appreciate, the appreciation will avoid estate tax on the surviving spouse’s death, regardless of the value of the surviving spouse’s assets.
3. You can allocate the deceased spouse’s exemption from the generation-skipping transfer tax (the “GST”) to the Bypass Trust. (The deceased spouse’s GST exemption is not “portable” but can be allocated to the Bypass Trust.) This can reduce GST taxes if you decide to leave assets to your grandchildren, either directly or in a trust for your children’s lifetimes and then for grandchildren.

There are certain situations that could arise where **having a Bypass Trust could provide a better tax result**, such as:

1. In 2013, the estate tax exemption could be reduced to a small amount (such as \$1 million). The \$5 million exemption is only set to remain in effect until the end of 2012, after which it is scheduled to revert to \$1 million unless a new law is enacted.
2. The surviving spouse (the “second spouse”) could remarry, and if the second spouse’s new spouse (the “third spouse”) dies before the second spouse leaving only a very small amount of unused exemption (or none), the surviving spouse can only use the unused exemption of his or her “last spouse” (the third spouse) and cannot use the unused exemption of the first spouse. If the first spouse had established a Bypass Trust, the first spouse’s exemption could have been preserved regardless of the situation with the third spouse.
3. The value of your assets might appreciate. While the \$5 million exemption of the surviving spouse will increase due to inflation, the amount of the deceased spouse’s exemption that passes to the surviving spouse due to portability is not adjusted for inflation. Appreciation occurring in the Bypass Trust escapes tax in the surviving spouse’s estate regardless of how much the assets grow in value.
4. You may have assets (such as real property) in a state that imposes a state estate tax, but does not have a portability rule for state tax purposes. There are currently 15 states plus the District of Columbia that impose state estate taxes (California does not) and none have yet adopted a portability rule.

On the other hand, **there are reasons you might not want to use a Bypass Trust**, including the following:

1. The surviving spouse will incur annual costs for the preparation of Bypass Trust income tax returns.
2. The surviving spouse will be required to maintain separate records for the Bypass Trust.
3. If the assets in the Bypass Trust (say, your home) appreciate in value during the surviving spouse’s lifetime, the assets will not obtain a further stepped up basis on the surviving spouse’s death. (The assets will receive a stepped up basis on the death of the first spouse, but only to the fair market value at that time.)
4. If there are changes in your children’s or grandchildren’s circumstances, then unless you give the surviving spouse the power to change the distribution terms for them, the surviving spouse will not be able to change the plan to adapt to the changed circumstances. For example, one of your children could develop a financial problem, and any assets inherited by that child would end up in the hands of the child’s creditors. Or, a child or grandchild could develop a significant problem (drug abuse, a bipolar condition, etc.). You could deal with this problem by granting the surviving spouse a limited power of appointment over the Bypass Trust, or you could simply choose not to establish a Bypass Trust.

5. In certain circumstances, there could be an adverse income tax result. For example, there might be a capital loss in the Bypass Trust and the surviving spouse might have a capital gain, but the two would not be offset.
6. Assets in the Bypass Trust generally cannot be used to implement further estate planning techniques, such as a Qualified Personal Residence Trust or a Grantor-Retained Annuity Trust.
7. If the personal residence is held in the Bypass Trust, the surviving spouse cannot utilize the \$250,000 exclusion from capital gain upon the sale of the residence.

As noted above, in order to claim the unused exemption of the deceased spouse, an estate tax return must be filed for the deceased spouse's estate, even if an estate tax return otherwise would not be due (because the estate is less than the threshold amount requiring the filing of a return).

If the non-tax reasons for having a Bypass Trust are not significant for you, and if your total estate (including the assets of both spouses) is under \$10,000,000, the changes in the estate tax may make the establishment of the Bypass Trust unnecessary. In that case, if you have a Bypass Trust, you would get the negative consequences of having a Bypass Trust but there may be no offsetting tax benefits.

Of course, there is no guarantee that the estate tax exemption will remain at \$5 million, or that this new law will stay in effect for more than two years. If the exemption is reduced between the death of the first spouse to die and the death of the surviving spouse, then having the Bypass Trust established could produce a better tax situation. Similarly, if the portability provisions are eliminated before the death of the first spouse to die but your plan is based on the assumption that portability will be in place, then your family might wind up paying more in taxes than would have been the case if you had established a Bypass Trust.

Planning Tip: If the non-tax reasons for having a Bypass Trust are not significant for you, but you want to provide for the possible establishment of a Bypass Trust in case your spouse decides that it is advisable to have one, then you might want to amend your estate plan to leave all of your assets to the Survivor's Trust, but include a provision that would allow the surviving spouse to "disclaim" a portion of the assets and have them pass into a Bypass Trust. With an appropriate provision in your Trust, the surviving spouse could make a decision to disclaim within the nine-month period following the first spouse's death, and the Bypass Trust would be established. The only "downside" of relying on a disclaimer to set up the Bypass Trust (rather than having it set up automatically) beyond the non-tax reasons discussed above, is that you cannot include a limited power of appointment in a Bypass Trust that is created by a disclaimer.