Estate Tax Concepts

BYPASS (CREDIT SHELTER) TRUST

Presented for

Valued Client

Presented by

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The Concept…

- A bypass trust (also called a credit shelter trust) is used by married couples to minimize federal estate taxes by fully utilizing the applicable exclusion amount for both spouses.
- The bypass trust also can provide asset protection, preserve estate assets for children and grandchildren, and provide income for someone other than a spouse.

The Process…

- When the first spouse dies, the estate is divided into two parts.
- The first part—an amount up to the available applicable credit amount, which is $5.49 million in 2017—is placed in the bypass trust. This amount avoids estate tax in the year of the first spouse's death.
- The other part of the estate may pass directly to the surviving spouse or be placed in a marital trust and held for the spouse's benefit. In either case, the unlimited marital deduction (available when a surviving spouse is a U.S. citizen) means that this part also escapes estate taxation, regardless of its value.
- A surviving spouse may receive income for life from the bypass trust, which is usually arranged so that principal deposited in the trust at the first death is retained for later distribution to heirs when the surviving spouse dies.
- In addition to receiving income, the surviving spouse may have certain rights to the principal, including the right to withdraw principal for health, education, support and maintenance needs, to exercise a limited power of appointment (including the ability to assign the principal to anyone except themselves, their estates, their creditors or the creditors of their estates), and to annually withdraw the greater of $5,000 or 5% of the principal.
- Despite rights to income and principal, when the surviving spouse dies, bypass trust assets are not included in the spouse's gross estate.
- When the second spouse dies, the bypass trust may either terminate or continue. All remaining trust assets are either distributed outright to the heirs, or continue in trust for their benefit. This is especially appropriate when the heirs are minor children or heirs who haven't demonstrated financial responsibility.
- Any assets owned by the surviving spouse outside the bypass trust will be included in the spouse's estate at death. However, strategies are available to help the surviving spouse reduce the potential estate tax liability.

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The Concept of Spousal Portability

- The estate of the first spouse to die can transfer the unused exclusion amount to the surviving spouse. For example, in 2017, if the husband dies first, and his estate only uses $2 million of the available $5.49 million applicable exclusion amount, the wife can add $3.49 million to her own estate tax exclusion amount.
- This aspect of the estate tax law provides a way to use both spouses' applicable exclusion amounts without a trust. However, a bypass trust offers benefits beyond estate tax savings.

Additional Benefits…

- Although bypass trusts are typically used by married couples to protect the surviving spouse, they can also be set up to provide income for others. For example, a trust might be payable to the couple's children or grandchildren, an aged dependent parent or other relative, or any other person the grantor chooses.
- Regardless of who is named the primary beneficiary (or beneficiaries) of the bypass trust, the same rules apply—the remaining trust assets at the primary beneficiary's death won't be included in his or her gross estate. Instead, the assets remain in trust to benefit the named successor beneficiaries without estate tax depletion.
- Bypass trusts may be set up with terms that suit a particular individual's needs. For example, the trustee or surviving spouse might hold a discretionary "sprinkling" power that allows for income to be variably distributed among the beneficiaries.
- Bypass trusts can offer asset protection in certain cases.

The Bottom Line…

It's vital to consider carefully the tax consequences of any customization of a bypass trust. Remembering that the primary goal is to shelter estate assets from avoidable taxation, the applicable exclusion amounts for both spouses should be used effectively so that no estate tax benefits are lost.

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SUMMARY

What Is a Bypass Trust?

A bypass trust is a device used to minimize a married couple's federal estate taxes by fully utilizing the applicable exclusion amounts of both spouses.

How Does It Work?

When the first spouse dies, the bypass trust receives that person's assets up to the amount exempt from federal estate tax under the tax law. So, for someone who dies in 2017, up to $5.49 million could be placed in the bypass trust to escape federal estate taxation. The bypass trust can also protect the assets, preserve them for beneficiaries such as children or grandchildren, and provide income for someone other than the surviving spouse.

The remainder of the deceased spouse's assets may go directly to the surviving spouse or into a marital trust. In either case, this portion isn't taxed at the first death because of the unlimited marital deduction available for surviving spouses who are U.S. citizens.

The bypass trust often pays income for life to the surviving spouse. The principal typically remains in the trust until the second spouse dies, when it passes to the heirs without being included in the surviving spouse's gross estate.

The surviving spouse may have rights to use the principal in several ways, including the right to invade principal for health, education, support and maintenance needs, the right to a limited power of appointment over the principal, and the right to annually withdraw the greater of $5,000 or 5% of the principal.

The surviving spouse may serve as trustee of a bypass trust, subject to certain limitations in the trust document so that the tax benefits in the arrangement won't be lost.

What Happens at the Second Death?

When the surviving spouse dies, all assets in the bypass trust go directly to the heirs. These assets "bypass" the second estate, so they are not included in the surviving spouse's gross estate. Alternatively, assets could remain in the trust for the benefit of the heirs, if desired.

Although bypass trusts are typically used by married couples to benefit the surviving spouse, they can also be set up to provide income for someone other than the spouse. A trust might be payable to the couple's children or grandchildren, for example, or for a dependent parent or other relative. Although the trust beneficiary is frequently a relative, that is not a requirement.

What Are the Benefits?

A bypass trust lets both spouses fully utilize the applicable exclusion amount permitted under the tax code. The trust can be set up to benefit not just the spouse but anyone—children, grandchildren or other relatives. Other minor adjustments to the trust terms can provide a “customized” trust arrangement to meet a variety of different needs, paying careful attention to the tax consequences.

The critical point to remember is that the primary goal in setting up a bypass trust is estate tax savings. It’s essential that the applicable exclusion amount of both spouses be used effectively so that no federal estate tax benefits are lost.

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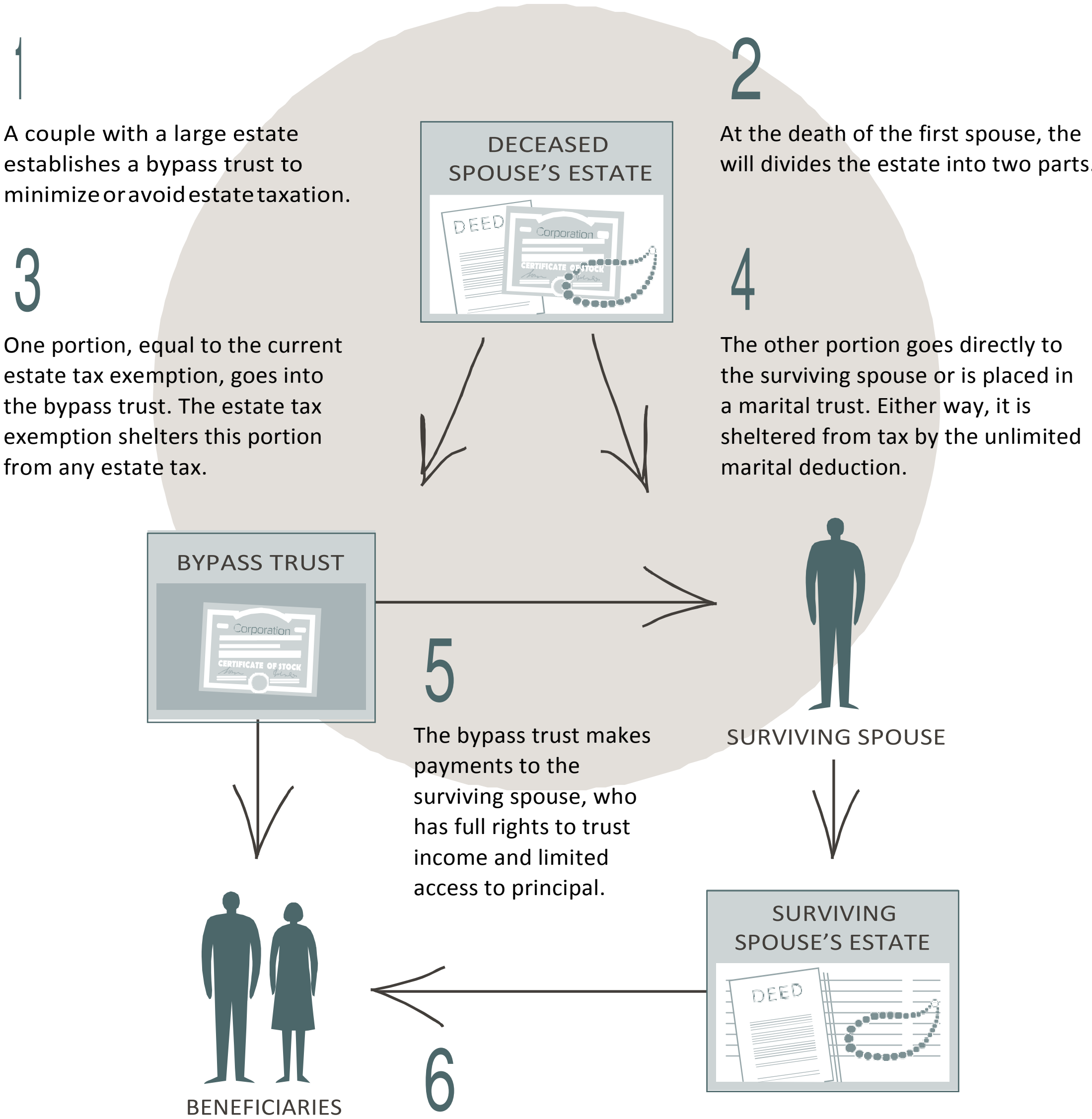

1 A couple with a large estate establishes a bypass trust to minimize or avoid estate taxation.

2 At the death of the first spouse, the will divides the estate into two parts.

3 One portion, equal to the current estate tax exemption, goes into the bypass trust. The estate tax exemption shelters this portion from any estate tax.

4 The other portion goes directly to the surviving spouse or is placed in a marital trust. Either way, it is sheltered from tax by the unlimited marital deduction.

5 The bypass trust makes payments to the surviving spouse, who has full rights to trust income and limited access to principal.

6 At the surviving spouse's death, the beneficiaries receive both the trust property and the estate assets. The bypass trust is not included in the gross estate.

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