BYPASS TRUST, EXEMPTION TRUST, B TRUST and FAMILY TRUST

What do I call thee, let me count the names. Bypass Trust, Exemption Trust, B Trust, and Family Trust are all the same type of trust. Prior to the tax act in 1997, the trust was also called the exemption equivalent trust or the credit shelter trust. This trust is the most basic tool in estate planning to reduce estate taxes for a married couple.

Let me begin with a little background. Most people do not need any tax planning in their Wills. The use of this trust saves taxes when a couple has a combined estate including insurance of more than the individual exemption, $1 million in 2003. How many people fall into this category? 1989 IRS figures reflect that in that year, only 2% of the individuals who died had an estate of over $600,000 (the exemption from estate tax in 1989) and only 7/10 of 1% had an estate of over $1 million. The rate of growth of estates since that time has been dramatic. In the April 1997 issue of American Demographics, the magazine noted that the number of individuals having an estate of over $1 million more than doubled between 1992 and 1996. The Millionaire Next Door stated that 3% of the households in America have a net worth over $1 million. Suffice it to say, even with the dramatic increase, the number is still very small. But if you are reading this booklet, you are probably in that small percentage.

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Let's assume that you and your spouse have a combined estate of $2,000,000 (twice the amount of the 2002 and 2003 exemption of $1 million). Therefore, each of you can give $1 million tax free. So no problem - right? Right, as long as you do not give anything to each other. Generally, a simple Will gives all of the property to the survivor outside of any trust and then provides that upon the survivor's death, the property is split among the children of the couple. In our example, this plan will result in an estate tax of $435,000 upon the death of the survivor if he/she died in 2003 (or after 2010) since the survivor has an estate of $2,000,000 and can only give $1 million without tax.

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Let's assume one marriage, one set of children, each spouse having the ability to manage property - in other words we are not trying to control the spouse's use of the property, manage it for him/her or ensure that *our* (as opposed to his/her)

children receive the property. Our objective in this situation is to give the survivor as much control over, and use of, the property without causing the property to be taxed in his or her estate. Enter the Bypass Trust.

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The Bypass Trust is a trust that is created upon the death of the first spouse to die. The provisions for the Bypass Trust are included in your Will or Revocable Living Trust. Your Will or Revocable Living Trust provides that you give an amount of property equal to the amount of the exemption to the Bypass Trust. A dollar amount is not used since the amount of the exemption can change and, in fact, is changing almost every year for the next eight years. The exemption is increasing over the next several years reaching $3.5 million in 2009, unlimited in 2010 and reverting to $1 million in 2011 as follows:

2004	1,500,000
2006	2,000,000
2009	3,500,000
2010	No estate tax
2011	1,000,000

If more than the exemption amount is placed in the Bypass Trust, a tax will be owed (except in 2010). However, if everything over the exemption amount is given to one's spouse, either outright or in a trust that qualifies as a gift to one's spouse, no tax will be owed. Since 1981, you have been able to give an unlimited amount to your spouse with no tax. This deduction is called the "marital deduction."

OK, so we have created a trust and we transfer property to the trust with a value equal to the exemption. Trusts have a bad connotation that someone else is controlling our money and deciding how much, if anything, that we should get. Well, that should never be the case, but that is another discussion. In this trust, we started with the premise that we would give our spouse the entire estate outright; we are not trying to protect our spouse from himself/herself, nor are we trying to preserve the property for distribution to our children.

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The trust is managed by the Trustee. The Trustee has the power to manage the property, decide on the investments and make decisions concerning the amount of the trust income and principal that is distributed to the beneficiaries. In other words, the Trustee has “Control”. Our spouse wants “Control”, so we name our spouse as the Trustee of the trust.

We also want our spouse to receive distributions from the trust and to be able

to use the property for his/her support. Our spouse is the beneficiary of the trust. Our spouse is either the only beneficiary of the trust, or if we also name our children as beneficiaries, then our spouse is the primary beneficiary of the trust.

Are there any restrictions, any catches to this structure? There is one restriction. If our spouse is the Trustee and the beneficiary and can distribute principal to herself/himself, then the trust must provide that the principal can be distributed only for certain purposes. The

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trust must provide an “ascertainable standard”; in other words, something which can be determined and enforced by a court. The most typical “ascertainable standard” is “health, education, support and maintenance according to her standard of living.” If the trust contains this provision, then the spouse can be the Trustee and the beneficiary, and the property will not be included in the spouse’s estate upon her/his death.

Note that the distribution for her support is according to her standard of living, so that distributions can be made to maintain the same living standard that she had while her spouse was alive. You may wonder then what is not considered "for her support." Well, she cannot distribute the property to someone else (e.g. subsequent spouse) or charity. She also cannot increase her standard of living. If she drove a Lexus and spent $150,000 per year on her living standard, she cannot now use the trust money to buy a Rolls Royce and spend $300,000 per year. However, she can use the money she has outside of the trust to buy the Rolls Royce and increase her standard of living. I’m not recommending this course of action, but she could do this.

What if she had the power to distribute the property to herself for her “comfort?" Since one could say that one needs any amount of money for one's comfort, your spouse could say that it comforts her to give the property to charity, to her new spouse, to her boyfriend, or to buy a Rolls Royce. Therefore, the term comfort is not considered an “ascertainable standard.” If your spouse can distribute the property to herself for her comfort, the power is too broad and is considered by the IRS to be the equivalent of outright ownership, and the trust assets will be included in her estate, thereby losing all of the benefits of the trust.

> In the situation outlined here, the Bypass Trust is a win/win choice.

Can we give our spouse any other type of power over the trust?

Yes, we can give our spouse the power to change how the property is distributed upon her death. As long as she cannot direct that the property be distributed to herself, her estate, her creditors or creditors of her estate, having this power will not interfere with any of the tax benefits of the trust. Although you will probably want to restrict the persons to

whom she can give the property, you could have the power be so broad that she could give the property to a subsequent spouse or to charity. Generally, this power is limited so that she can change the manner in which the property is distributed to your children (e.g., hold the property in trust for a period of time), but she cannot give it to people outside of your family. This power is called a "special power of appointment."

Let's assume we've set up the Bypass Trust and funded it with the exemption amount. Let's also assume that our estate was not just $2,000,000 but was $4 million total. $1 million would be held in the Bypass and our spouse has property valued at $3,000,000. On her death, a tax of up to $945,000 will be owed depending on the year of our spouse's death. First, we recommend that she live to at least 2009 and that Congress votes to retain the $3.5 million exemption. What other type of planning would be helpful in this event to reduce the tax which is owed?

The property in the Bypass Trust will not be included in our spouse's estate upon her death, but the property is always available to her. The property is not taxed on our spouse's death even if the property has doubled or tripled in value. Hmmm, this leads to a plan. Let's say that our entire $4 million estate yields an income of $150,000 per year, the exact amount of money our spouse needs to maintain her standard of living and has non income producing growth assets. If we transfer $1 million of growth assets to the Bypass Trust, our spouse retains the income assets and the growth will not be included in her estate. If our spouse needs additional funds, it is better for our spouse to use assets outside of the trust since these assets will be included in her estate.

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In the situation outlined here, the Bypass Trust is a win/win choice. The spouse need only maintain a separate account for the trust and file separate tax returns for the trust. She can manage the property and can use the property for her support if she needs it and save hundreds of thousands of dollars in taxes for your children in doing so.

WHAT IF REPEAL STAYS?
IS THE BYPASS TRUST GONE ALSO?

The short answer is, definitely not. First, the trust also provides benefits for the spouse such as protection from creditors and from estranged future spouses (an area where we definitely want to protect our spouse). In addition, even with a full repeal of the estate tax for an indefinite period (i.e. no automatic reinstatement) cannot be counted on to last. With a budget shortfall, a different economic climate and a different mix in Congress, a tax law protecting only a fraction of the top 1% is likely to be targeted. The Bypass Trust will continue to be a protection to our families from creditors, estranged spouses and potentially, from taxes.

WHAT ABOUT A LIFETIME BYPASS?

Sounds like heart surgery. Some people may prefer to have surgery than give property away during their lifetime. However, one of the points I keep making in my discussions are the benefits of

compounding. Several years ago, a couple in their 80s came into my office for estate planning. They had an estate of about $1.3 million, all community, no tricky aspects like a large retirement account. I prepared Wills which created Bypass Trusts for each of them. Fast forward three years, I receive a call. One of their main assets was Dell stock. Their estate was then worth over $4 million. Whoa, was there a way to have frozen our estate at $1.3 million and avoided all tax several years ago? Yes, and no. There are ways to transfer the appreciation on assets to our children. E.g. see the discussion on "Grantor Retained Annuity Trusts" and "Defective Grantor Trusts."

But this couple wants to retain the property for *their own* use and not give it to their children. They do not know what their future needs will be. Taking a step like transferring all appreciation to their children would be a case of having the "tax tail waging the dog". Could they transfer property to a Bypass Trust during their lifetime? I have used this technique, but there are a number of caveats in taking this step. First, if I create a trust for you with $100,000 and you create a trust for me with $100,000. The IRS says these are "reciprocal trusts" and it is treated as if I created a trust for myself with $100,000 and you created a trust for yourself with $100,000. If interpreted as a trust that I create for myself, the entire trust is included in my estate, no benefit gained. However, let's make the trusts different. Maybe only my children are beneficiaries for the first ten years of the trust and then I become a beneficiary. You are the sole beneficiary of the trust I create for you. These trusts should be considered sufficiently different not to be treated as reciprocal trusts. However, this hurdle is only one of the hurdles in this situation. Let's return to our couple. Let's assume each of them creates a trust for the other and we have made the trusts sufficiently different to avoid the reciprocal trust rule. When one of the spouses dies, only one trust is left. If husband creates a trust for wife and wife creates a trust for husband, when husband dies, only the trust for wife remains since wife has given her half of the property to husband and he is now deceased. If the couple divorces the same effect occurs, it's as if you have preplanned a division of property on death or divorce. Bottom line, these trusts may be extremely beneficial but the circumstances in which they fit are very limited.

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In addition to the caveat of the impact of divorce, the couple must have sufficient funds to give the exemption amount directly to their children. If the couple is in this position, losing the benefit of one of the trusts upon one of their deaths (or divorce) will not affect them. Second, the differences in the two trusts must be

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compatible with the couple's needs. Generally, situations in which the creation of trusts structured in this manner works are ones which are used in an estate in the $2 to $5 million range or in a situation where the trust is funded with a relatively small amount of property with the potential for dramatic appreciation.