

Are Bypass Trusts Still Relevant?

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During the past several decades, estate planners recommended the use of AB Trusts for nearly every client. The use of AB Trusts was based upon the fact that the estate tax applicable exemption amount (“AEA”) was not automatically “doubled” if one was married. The AB Trust was developed to solve this problem, by providing that the deceased spouse’s exemption amount would be funded to a “B” trust at the first death. The IRS came to accept this “loophole”, leading to the proliferation of AB Trusts. AB Trusts became so common that “Trust Mills” and software programs began churning out virtually identical trusts for every client. While creating other problems, these mass produced Trusts usually worked in reducing estate taxes. Today, many are getting “stuck” with an AB Trust upon the death of their spouse, in a world where AB Trusts are no longer useful. This article examines the common problems of AB Trusts, and what to do if you get “stuck”.

Why AB Trusts are No Longer in Fashion

Most individuals currently do not need a Bypass Trust for estate tax avoidance given the high exemption amount. With a \$5.25 million exemption amount, set to increase each year with inflation, it is probably not necessary to double the exemption using an AB Trust, unless one has an estate above \$3.5 Million or so (pick your own number, based on the likelihood the total estate will exceed the inflation adjusted AEA upon the survivor’s death). Even so, now the law allows the “portability” of an unused exemption with the IRS by filing an estate tax return for the surviving spouse. In other words, with portability, one can get almost the same effect as a Bypass trust by filing a tax return instead of creating a trust. However, for many, there could be certain advantages to keeping an AB Trust in place (more below).

More than being unnecessary, keeping a Bypass trust in place may actually harm you and your family. First, the Bypass trust limits what the spouse can do with the deceased spouse’s estate. Typically, a Bypass Trust will provide that the surviving spouse will receive all income and principal for her health, education, maintenance, or support. The distribution of all income prevents the spouse from having to report income in the Trust’s income tax bracket. The limited ascertainable standard for distributions of principal was necessary for keeping the Trust out of the estate of the surviving spouse. In layman’s terms, this means that the spouse can’t use the Bypass trust to fund her vacation or discretionary spending unless her survivor’s trust is exhausted. Usually this was an acceptable sacrifice for saving millions of dollars in estate tax. Today, it is less acceptable when the spouse can get many of the same estate tax savings through portability.

Second, keeping the Bypass trust in place may mean incurring unnecessary capital gains tax. For background, cost basis is generally the price paid for an asset. Gain is typically recognized when an asset is sold at a price above the cost basis, resulting in capital gains taxes. However, cost basis is usually “stepped up” upon the death of the owner, generally resulting in tax savings for the beneficiaries of an asset. The AB Trust will typically provide that a fixed dollar or percentage amount of your deceased spouse’s assets be funded to the Bypass “B” trust. Since those assets funded to the Bypass trust are not “owned” by the surviving spouse, the assets held therein will not enjoy a basis step up upon his or her death. As a result, the beneficiaries may end up paying more taxes than if the Bypass trust hadn’t been set up in the first place. These effects are compounded when the beneficiaries live in a State like California, where capital gains are taxed at some of the highest state income tax rates in the country.

Finally, the Trust may result in avoidable administrative expense. The funding process will involve a certain degree of administrative expense because the surviving spouse (who is typically Trustee) needs to value all assets as of the date of death, fund them into the Bypass trust, obtain a tax ID number, and possibly begin to file form 1041s for the new Trust. Appraisals will also have to be ordered for all assets, which will not be cheap. If the spouse does *not* fund the Bypass trust, or does so late, the IRS may later come back and assess penalties.

Are There Any Positives to a Bypass Trust?

On the other hand, a Bypass trust may have certain advantages, particularly for larger estates. First, a generation skipping transfer tax (“GST”) exemption may be allocated to a Bypass trust. Such an exemption is not available with a “portability” election. Second, a Bypass trust may allow for income tax arbitrage. For instance, including multiple beneficiaries of the Bypass trust (i.e., the spouse and your children), with a flexible distribution of income provision, could permit significant income tax savings by distributing out income directly to beneficiaries with lower income tax brackets. Third, a Bypass trust offers asset protection to spouses and other beneficiaries by shielding the trust assets therein from creditors and predators. Fourth, a Bypass trust offers “bloodline protection” by offering the ability to lock in the remainder beneficiaries of the trust. Finally, a Bypass trust allows all future appreciation in the Trust to pass estate tax free to beneficiaries. A portability election, by contrast, does not capture future appreciation after the death of the first spouse to die.

Potential Solutions

If you have an AB Trust in place, particularly if it was a mass produced trust, it probably is time to have it reviewed and updated. In many cases, the advantages of the Bypass trust will be outweighed by the complexities and income tax problems involved. A clever in-between solution may be to provide for a “disclaimer trust”, which gives the option to the surviving spouse whether to create a Bypass trust. As opposed to a strict formula which allocates a fixed amount to the “B” Trust, a disclaimer trust gives total discretion to the spouse whether to create and fund

the “B” Trust. On the other hand, a “disclaimer option” will not be appropriate for clients who have very large estates or who want to guarantee some of the other benefits of the “B” Trust.

For others who like the benefits of a “B” trust, but would rather avoid the capital gains tax problems, consider using an “A-C” trust instead. The “C” Trust refers to the marital trust, which is generally drafted as a qualified terminable interest property trust (“QTIP”). These trusts are generally used to capture the “overflow” from a Bypass trust when there were more assets in the deceased spouse’s estate than the AEA. However, there is no reason why a “C” trust cannot be used even when there is no need for a “B” trust. Such a trust offers the benefits of asset and bloodline protection when drafted properly. Since the trust is includable in the surviving spouse’s estate, the assets will be “stepped up” upon the death of the surviving spouse. The trust also does not result in income at the trust’s income tax rates because all income is required to be distributed to the surviving spouse at least annually.

If your spouse has just passed away and you had an AB Trust in place, you are in a challenging situation. You are required by the terms of the trust to fund the Bypass trust according to the instructions contained therein. If you fail to fund the Bypass trust or do so late, the IRS may assess penalties, taxes, and interest. This is unfortunate particularly when the Bypass trust is no longer necessary for estate tax minimization. But don’t worry, in most cases you are not completely “stuck”.

For Californians, an alternative to facing the ire of the IRS or an unnecessary B trust funding is to modify the trust by court procedure. The California Probate Code under sections 15200 et seq. provides a procedure whereby such a trust may be modified, even after the death of the first spouse. In some counties (i.e., San Mateo and Santa Clara Counties), this author has had success in modifying AB trusts in a single court appearance. Such petitions require a re-write of the Trust and judicial approval. Also, an estate tax return should generally be filed in order to preserve asset values for cost basis and portability purposes.

If you find yourself in the situation where your spouse has just passed away and you had an AB Trust in effect, you should seek counsel. Our Menlo Park estate planning attorneys have successfully modified AB Trusts by court procedure for many clients. If you have an AB Trust in place and both you and your spouse are still living, consider updating your estate plan with a qualified trusts and estates attorney.

If you require counsel, contact a [Menlo Park trusts and estates attorney](#) today.

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