

Don't Count Out The Bypass Trust

To paraphrase Mark Twain, the reported demise of the bypass trust may be greatly exaggerated. In fact, this estate planning technique is still a viable option for many individuals and may actually stage a "revival" in future years.

Reasons For The Change

For decades, a bypass trust was a staple of estate plans of wealthier families. But two key factors have effectively reduced the use of such trusts in recent years: the increased gift and estate tax exemption and the "portability" provision.

As its name implies, a bypass trust (sometimes called a credit shelter trust) is designed to allow assets to bypass your spouse's estate before others, typically children and grandchildren, inherit the property. Because the trust effectively uses the full estate tax exemption for each spouse, it may enable a married couple to transfer millions of dollars without paying any federal estate tax.

In the usual setup involving a married couple, each spouse includes a provision in his or her will establishing a trust for the surviving spouse's benefit and funds it with the equivalent of the deceased spouse's basic exemption amount. Then, when the surviving spouse dies, the remaining assets go to the designated beneficiaries. If the trust is structured properly, this arrangement may avoid estate tax by using the estate tax exemptions of both spouses.

But here's the rub: the exemption amount has been significantly boosted since near the turn of the century (see "Evolution of the gift and estate tax exemption" below). Currently, it's set at \$10 million through the end of 2025, indexed annually for inflation. The exemption amount for 2022 is \$12.06 million (up from \$11.7 million in 2021).

Furthermore, estate tax planning has been enhanced by the portability provision initially created in 2010 and subsequently made permanent. Under this provision, any portion of an exemption not used by the first spouse to die becomes available to the surviving spouse's estate. In

other words, a couple now can transfer double the exemption amount – without estate taxes – no matter who the nonspousal beneficiaries are.

As a result, the estate tax benefits of using a bypass trust have been curtailed, yet bypass trusts are hardly obsolete. There are still several potential reasons to include a bypass trust within your overall estate plan.

Benefits Of A Bypass Trust

For starters, assets that are owned individually by a surviving spouse generally become “fair game” for creditors. This can be especially bothersome to family members if a significant amount of assets is siphoned off to help pay the debts of someone who marries the surviving spouse. However, a bypass trust can protect the assets from the clutches of creditors.

Although the children may be named as the successor beneficiaries in the respective wills of a married couple, that could change, especially if a surviving spouse eventually remarries. There’s no guarantee that the children of the initial marriage will receive their fair share of an inheritance on the death of the surviving spouse. With a bypass trust, you can arrange for the assets to pass to your children and grandchildren, regardless of any future marriages by a surviving spouse.

In addition, remarriage isn’t the only financial concern of a married couple. Assets can be diluted through reckless spending by the younger generation or financial interests might be assigned to others. By including a spendthrift provision in a bypass trust, you can guard against these potential dangers, while still allowing the beneficiaries to use assets in a reasonable manner.

Also, note that a bypass trust can provide flexibility by granting a power of appointment to a surviving spouse. Doing so can give this person legal authority to use trust assets for health care, education or other costs. As opposed to a broad general power of appointment, a limited power may permit the beneficiary to allocate only their share of the trust among classes of potential recipients.

The Right Trust?

A bypass trust remains a valuable tool in your estate planning toolbox. Bear in mind that the gift and estate tax exemption is scheduled to revert to \$5 million in 2026 (indexed for inflation). The reduced amount may not be sufficient for your family's estate planning needs. A bypass trust may become even more important as a complement to other techniques. Discuss with your estate planning advisor whether a bypass trust is right for your estate plan.

SIDEBAR: Evolution Of the Gift And Estate Tax Exemption

Before the enactment of the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) in 2001, the estate tax exemption was a relatively modest \$675,000. But then EGTRRA pushed the exemption up over \$1 million.

The exemption gradually increased to \$3.5 million in 2009 before the estate tax was repealed for one year (2010). After 2010, the exemption was increased to \$5 million, subject to inflation indexing. Finally, the Tax Cuts and Jobs Act doubled the exemption amount to \$10 million, with inflation indexing, for 2018 through 2025. Currently, it's scheduled to revert to \$5 million (again indexed for inflation) in 2026 – unless Congress takes action.

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