

DO YOU REALLY NEED THAT AB TRUST? BENEFITS OF SIMPLICITY IN TRUST DESIGN

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Benefits of Simplicity in Trust Design

ESTATE PLANNING

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HOGGE • FENTON

I. Introduction

Over the last few years, the tax concerns of married couples have pivoted from estate tax avoidance to income tax avoidance. Complicated and administratively burdensome trust designs are no longer necessary for the positive trade-off of estate tax avoidance for clients with estates smaller than the unified transfer tax basic exclusion amount (“exclusion”). Instead, an estate plan providing all assets either outright to a surviving spouse, or in trust for a surviving spouse, can meet a couple’s goals by avoiding estate tax, easing administration, and reducing income tax exposure.

This article will provide a brief history of a bypass trust, and its advantages and disadvantages. The techniques discussed in this article primarily benefit clients with estates less than a single estate tax exclusion (\$12,920,000.00 in 2023), or less than a combined exclusion where the surviving spouse elects portability of the deceased spouse's unused exclusion amount.

II. Background of the Bypass

A bypass trust (also referred to as a credit shelter trust or a tax exemption trust) is an estate planning tool commonly used in trust designs referred to as "AB Trusts" or "ABC Trusts." In these trust designs the "A" trust (also referred to as a surviving spouse's trust or survivor's trust) grants the surviving spouse full power and control over the A trust assets (generally, the surviving spouse's separate property and one-half interest in the couple's community property); and the "B" or bypass trust typically grants the surviving spouse distributions of all net income and principal distributions under health, education, support, and maintenance ("HEMS") standard, but prevents the surviving spouse from changing the distribution scheme or invading the principal for purposes outside of the HEMS standard. The bypass trust is typically funded with the deceased spouse's separate property and one-half interest in the couple's community property or perhaps is only funded up to the deceased spouse's unused estate tax exclusion amount, with the remainder funded to the A trust.

Alternatively, in a typical ABC Trust design, the excess of assets over the deceased spouse's estate tax exclusion will instead be assigned to the "C" Trust (also referred to as a marital trust, qualified terminable interest property ("QTIP") trust, or marital deduction trust).

Under the above trust designs, at the second death, the assets in the A and C trusts are includable in the surviving spouse's taxable estate.^[i] However, the bypass trust receives special treatment and "bypasses" the surviving spouse's taxable estate, passing to the remainder beneficiaries' estate tax-free, because the surviving spouse does not have sufficient ownership over the assets. The assets allocated to a bypass trust can appreciate completely free of further estate tax before passing on to the trust beneficiaries.

Due to the significant estate tax savings of a bypass trust, these trust designs have been popular amongst estate planners and their clients. Many estate plans in existence include bypass trust provisions.

III. Changing of the Guard

Under the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the "2010 Tax Act"), for the calendar years 2010, 2011, and 2012, there was a \$5 million estate and gift tax exclusion, indexed for inflation. In 2012, the indexed amount was \$5,120,000. This allowed an individual to dispose of up to \$5.12 million to heirs without paying estate taxes. The law also permitted exclusion "portability" between spouses, which allowed a surviving spouse to use his or her predeceased spouse's unused estate tax exclusion. Assets above the exclusion amount were subject to a 35% estate tax rate. These amounts were scheduled to return to the pre-2001 estate tax level on January 1, 2013, which included a \$1.0 million estate tax exclusion and a 55% estate tax rate. Additionally, the portability provisions would expire.

On January 1, 2013, the U.S. Congress passed the American Taxpayer Relief Act of 2012 (the “2012 Tax Relief Act”). The 2012 Tax Relief Act was signed into law by President Obama on January 2, 2013. The 2012 Tax Relief Act made permanent the changes made by the 2010 Tax Act. It provides for a \$5.0 million dollar estate tax per-individual exclusion (including an annual inflation adjustment), a 40% tax rate, and portability of unused exclusion by the surviving spouse. In 2016, the indexed exclusion amount is \$5,450,000.

The changes in the 2012 Tax Relief Act for estate, gift, and generation-skipping transfer taxes were made permanent. The estate and gift tax system will continue to be unified. The exclusion and rates for gift and generation-skipping transfer taxes are the same now as the estate tax exclusion and rates.

The Tax Cuts and Jobs Act of 2017 temporarily doubled the estate, gift, and generation-skipping transfer tax exemption from \$5 million, adjusted for inflation, to \$10 million, adjusted for inflation. In 2023, the inflation-adjusted exemption amount is \$12,920,000 per person. This increase is scheduled to expire at the end of 2025. After that, the exemption for estate, gift, and generation-skipping transfer tax, will revert back to \$5 million, adjusted for inflation.

IV. Advantages and Disadvantages of a Bypass Trust

A. Advantages

Although many clients are interested in simplicity, and avoiding the extra paperwork and time the establishment and administration of a sub-trust entails, a bypass trust can provide protections that may be of higher value to clients than reducing the complexity of their estate plan.

First, a bypass trust provides asset protection. Generally, a surviving spouse’s assets are susceptible to creditors and, perhaps, depletion by children or a new significant other. However, an appropriately funded bypass trust protects the assets from creditors, and, at least theoretically, protects the assets from being inappropriately used by the surviving spouse to, for example, pay the debts of a new spouse or a free-spending child.

Second, a bypass trust safeguards the testamentary intent of the deceased spouse. This is particularly relevant in a blended family, where each spouse may want to ensure that their share of the estate is “locked in” for their chosen beneficiaries (perhaps children from a prior marriage), and not instead distributed only to the surviving spouse’s beneficiaries, to the exclusion of the deceased spouse’s beneficiaries, or to a new spouse.

Further, a bypass trust’s distribution provisions need not be completely inflexible for the surviving spouse. The bypass trust language can incorporate a limited power of appointment for the surviving spouse so the surviving spouse may appoint the assets amongst a class of beneficiaries (e.g., “the issue of the deceased spouse”). This can be useful in, for example, a case where a child did not need a special needs trust at the time the trust was drafted, but after the decedent spouse’s death, a special needs trust was preferred. The surviving spouse would be able to appoint the assets to a new special needs trust to provide for that child, rather than have the bypass trust assets locked into

the existing distribution scheme.

Third, because the deceased spouse's Generation Skipping Tax ("GST") exemption is not portable, the bypass trust can maximize the use of the deceased spouse's GST exemption by allocating it to a GST-exempt bypass trust, preserving the GST exemption for a lifetime of children's trusts.

Fourth, a bypass trust protects the growth of the assets in the trust from further estate tax on the surviving spouse's death. A five million dollar property or stock portfolio can be allocated to the bypass trust on the decedent spouse's death, be available for the surviving spouse's use and benefit during his or her lifetime, grow to eight million dollars, then pass estate tax-free to the bypass trust beneficiaries without being subjected to further estate tax.

B. Disadvantages

A major disadvantage of a bypass trust is the loss of the second income tax basis step up at the death of the surviving spouse for the assets in the bypass trust. When someone dies, the capital basis of the person's assets, with certain exceptions, is adjusted to the fair market value at the person's date of death. This is commonly referred to as the "stepped-up basis." The more formal term for this is capital basis adjustment. The exceptions to this basis adjustment are for cash, life insurance, and income with respect to decedent items. For the assets of a decedent to qualify for the capital basis adjustment, the assets must be includable in the taxable estate of the decedent. In an all-community property estate, at the first death, all assets that are eligible for the capital basis adjustment will receive an adjustment upon the death of the first spouse to die. The basis adjustment affects any gain or loss on a later sale of the asset. The basis adjustment also resets the depreciation value for depreciable assets and frequently results in a higher depreciation deduction for the surviving spouse. Where there is a bypass trust in place at the second death, the assets in the bypass trust do not receive the second capital basis adjustment. However, if the assets that might otherwise have been allocated to a bypass trust, are instead includable in the taxable estate of the surviving spouse by being allocated to the surviving spouse or marital trust, those assets will receive a second capital basis adjustment at the death of the second spouse.

So, although the assets in the bypass trust receive a step-up in basis on the first death, the assets do not receive a second step-up in basis on the surviving spouse's death. Therefore, upon a sale or exchange of a capital asset held by the bypass trust, any post-first-death appreciation would be subject to income tax. This may cause a significant income tax liability for the remainder beneficiaries that may outweigh the benefit of any estate tax avoidance provided by the bypass trust. This is especially true if the assets must be liquidated upon the second death to achieve the distribution design of the estate plan.

If, instead, the bypass trust was removed from the estate plan and the assets were included in the surviving spouse's taxable estate, the assets would receive a second full capital basis adjustment on the surviving spouse's death.

As an example, Bill and Betty own real property in California and have an AB trust design. Bill died in 2013, at which time Bill and Betty's combined community property estate was \$7,000,000. The bypass trust was funded with \$3,500,000 in real property, and the survivor's trust was funded with \$3,500,000 in real and personal property. Betty then dies in 2015, with the survivor's trust valued at \$5,000,000 and the real estate in the bypass trust appreciated to \$5,000,000. If the bypass trust beneficiaries choose to then sell the real estate, they face income tax on the \$2,000,000 value increase.

However, if Bill and Betty had amended their trust to a survivor's trust only, or a survivor's trust and marital trust design, or if, after Bill's death, Betty took steps to terminate the bypass trust, all of the assets would have been included in Betty's taxable estate. As a result, those assets would have received a second step-up in basis. The remainder beneficiaries could then sell the appreciated real estate without significant negative income tax consequences. In addition, had Betty elected portability after Bill's death, at her death, there would be no taxable estate, as Bill and Betty's combined estate tax exclusions would exceed the \$10 million total estate.

Another significant drawback to a bypass trust is the cost of creating, funding and maintaining the trust. The trustee of the bypass trust must obtain a separate tax identification number, maintain separate books and records, and prepare and file separate tax returns every year. Additionally, the bypass trust complicates the surviving spouse's individual income tax returns, which must track the income received from the bypass trust.

Further, because the bypass trust is irrevocable, the surviving spouse, as the trustee, owes fiduciary duties to the remainder beneficiaries. Unless the trust law is modified in the trust document, the trustee owes a duty of loyalty, a duty of impartiality between the income and remainder beneficiaries, a duty to keep books and records, and a duty to render an accounting.^[ii]

V. Summary

Each client couple must review their estate plan periodically. It may be that the benefits of the Bypass Trust continue to outweigh the disadvantages. For other clients, the disadvantages may outweigh the benefits. Each client's situation is unique. Periodic review, and, perhaps, modification to the estate plan, is the only certain way to achieve optimal results.

^[i] The A trust is always included in the surviving spouse's estate, as the A trust assets are owned entirely by the surviving spouse under IRC, section 2031. The C trust takes advantage of the marital deduction under IRC, section 2056(b)(7), and, as a result, its assets are included in the surviving spouse's estate, under IRC, section 2044.

^[ii] Frequently, the trustee of the bypass trust is the surviving spouse. In addition, the surviving spouse is generally the current, or income beneficiary of the trust. If the surviving spouse is the trustee and the current income beneficiary of the trust, the trustee does not have a duty to render annual accountings unless the trust document states otherwise. However, it is common practice to include as permissible principal beneficiaries of a bypass trust, the children of the couple. In such cases, there is a duty to render annual

accountings.

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