

By-Pass Trust

What Is a Bypass Trust?

Under this arrangement, at the death of the first spouse, the estate is divided into two parts. One part, equal to the applicable exclusion amount sheltered from tax by the applicable credit amount, is placed in a trust that may provide liberal benefits to the surviving spouse, but will bypass his or her estate at death. (Currently, this amount is \$2,000,000. It will increase to \$3,500,000 in 2009.) The other part either passes outright to the surviving spouse, or is placed in a marital deduction trust for the spouse's benefit.

The general idea is to make full use of the applicable credit amount at each death. If everything passed outright to the surviving spouse at the first death, it could all be subject to estate tax at his or her later death. But by using the applicable credit amount to shelter assets at the first death, this amount (and more if the property has gone up in value) can escape estate taxation at the second death.

The property placed in the bypass trust does not qualify for the marital deduction at the first death. Nevertheless, no estate tax is due on the assets put into the bypass trust because the applicable credit amount sheltered these assets from federal estate taxation. Further, no estate tax liability will be incurred on the property passing via the marital deduction to the surviving spouse. So, there are no federal estate taxes at all at the first death. Then, at the second death, the surviving spouse can use his or her own applicable credit amount to shelter additional assets.

General Design of a Bypass Trust

The Bypass Trust should include the following basic provisions:

- distributions of principal for purposes of health, education, support and maintenance
- a limited power of appointment over the trust principal, which means the spouse can appoint the principal to anyone except herself, her estate, her creditors and the creditors of her estate
- an annual right to withdraw the greater of \$5,000 or 5% of the trust principal.

Even if the spouse does have these powers and privileges, the bypass trust will not be included in the second estate. Note that the one thing the surviving spouse cannot do is control the final disposition of the trust, except within the constraints of any limited power of appointment that he or she may be given. The final disposition is controlled instead by the trust terms, as established by the first-to-die spouse.

Income Accumulation

Some first-to-die spouses are reluctant to have all trust income paid out to the surviving spouse. Instead, the trustee is given discretion to pay out or to accumulate income. The trust usually provides some standard for the trustee to use in exercising such discretion, related to the spouse's needs for income.

If income is accumulated in the trust, the trust becomes a separate taxpayer. However, the trust reaches higher tax brackets much more rapidly than an individual, so there may be significant disadvantages to retaining income. See the tax schedule below.

2007 Federal Estate and Trust Tax Rates	
If taxable income is:	The tax is:
Not over \$2,150	15% of the taxable income
Over \$2,150 but not over \$5,000	\$322.50 plus 25% of the excess over \$2,150
Over \$5,000 but not over \$7,650	\$1,035.00 plus 28% of the excess over \$5,000
Over \$7,650 but not over \$10,450	\$1,777.00 plus 33% of the excess over \$7,650
	\$2,701.00 plus 35% of the excess over \$10,450

Sprinkling Trust

In the sprinkling trust, the trustee is given the power to "sprinkle" income--and maybe principal also--among several beneficiaries, say, the spouse and children. If the spouse is already in a relatively high income tax bracket, this can substantially reduce the family tax burden while still keeping all the trust income within the family unit. Sometimes it is the surviving spouse who holds the "sprinkling" power rather than the trustee.

The spouse can safely do this without undoing the estate tax benefits at her death so long as she cannot exercise her powers to sprinkle income to herself or in any way for her own benefit. For example, if she has an obligation to support children who are still minors, she should not be able to exercise her sprinkling power so as to discharge her own support obligation.

Giving the trustee or surviving spouse a sprinkling power enables the first-to-die spouse to avoid carving in stone the distribution of trust income and principal before "all the facts are in." Some of the children will undoubtedly have greater financial needs than others, and the sprinkling provision allows this to be taken into account after the first spouse's death.

The Five-and-Five Power

Further, in the year the surviving spouse dies, the amount he or she could have withdrawn in that year is included in the gross estate even if he or she did not in fact withdraw it. If we think of 5% of a \$1 million trust, that would mean an extra \$50,000 in the gross estate.

Because of these potential tax problems, some trusts just give the spouse a right to borrow from the principal of the trust instead of the withdrawal power. Thus, the spouse has access to the principal without potentially adverse tax consequences.

Review of Bypass Trust Advantages

- The property placed in the bypass trust will be included in the gross estate of the first to die. However, there should be no estate tax liability because the estate tax on those assets will be offset by the applicable credit amount.
- The property placed in the bypass trust will usually pass outright to, or be retained in trust for, the children at the death of the second to die. The value of the trust will not be included in the gross estate at the second death.
- The spouses will make maximum use of their respective applicable credit amounts at each death.
- The surviving spouse can receive the income from the bypass trust for his or her lifetime, and also have fairly liberal rights to withdraw principal. Alternatively, the income may be accumulated, or distributed to the spouse and other beneficiaries in the discretion of the trustee.

- The first spouse to die is assured that the property placed in the trust will ultimately pass to those he or she wishes.