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A Contrarian View on Bypass Trusts

By Jonathan Kinney

There are a number of good reasons to consider using a standard revocable trust, including minor children, spendthrift credit protection and to ensure funds go as you intended (i.e. a second marriage situation). However, a bypass trust, particularly for married couples with assets between $6 million and $10 million, may not always present the best scenario given the current applicable $5.34 million "exemption" from estate taxes for each individual and portability to the surviving spouse of a deceased spouse's unused exemption. There are situations, particularly for married couples with adult children, where the best plan may be to rely on portability and a standard will rather than a bypass trust.

Portability effectively provides that the surviving spouse can carry over any portion of the applicable exemption amount into his or her estate that was not used by the spouse who was the first to die. However, portability is not automatic. The surviving spouse still has to file an estate tax return on the death of the first-to-die spouse even though no estate tax will be due.

What are the situations that make reliance on portability attractive?

- If there is a high probability that adults will be the only beneficiaries of the estate with the consideration that such adults will have the maturity to handle large lump sum payouts.
- When combined assets of a married couple is below $10 million.
- Residency in Virginia or one of the other 30 states without an estate or inheritance tax.

What are the situations that may not make reliance solely on portability attractive?

- Residency in the District of Columbia, Maryland or one of the states with a relatively high estate or inheritance tax structure or where there is no portability of the spouse's exemption amount.
- When minor children may be the beneficiaries of the estate. Without testamentary provisions for minors in a will or trust, a beneficiary will receive his or her full bequest upon reaching the age of 18.
- When generation skipping taxes (GST) are a consideration. Married couples are not able to fully use the GST exemptions of both spouses if they rely solely on portability as the means to secure their respective estate tax "exemptions."
- Concerns about asset protection. By holding assets in trust, the trust can be used for the beneficiary's benefit while preventing the beneficiary's creditors from seizing the inheritance.
- Younger couples where the spouse may remarry after the death of the first-to-die spouse.

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Why does portability make a difference?

It effectively doubles the exemption amount for the combined assets of a marriage ($10.68 million). Prior to portability, estate planners would recommend establishing a bypass or credit shelter trust. A bypass or credit shelter trust effectively accomplishes the same result by taking advantage of the unlimited exemption amount afforded the transfer of assets from one spouse to another. The bypass trust establishes both a family trust and a marital trust within the bypass trust. The family trust includes the amount equal to the then-current federal exemption amount and is available for the support and maintenance of the entire family. The marital trust is funded with the remainder amount and reserved for the exclusive use of the surviving spouse. The family trust assets would, upon the death of the second spouse, "bypass" the second-to-die spouse's estate and be fully exempted from the estate tax of either spouse's estate.

Why could a bypass trust be less attractive?

Even with that advantage, a bypass trust may be less attractive in certain situations connected to the stepped-up basis of assets given the recent changes in capital gains taxes.

With portability, the cost basis of an asset is stepped-up to its value as of the date of death of the second-to-die spouse. In Virginia, if a beneficiary to a married couple's estate valued under $10.68 million sells his or her inheritance immediately after the time of death of the second-to-die spouse, the beneficiary will not incur any federal or estate taxes. He or she is also unlikely to have any ordinary income or capital gains repercussions. However, a beneficiary of an asset in the family trust of a bypass trust will not receive such a stepped-up basis at the death of the second-to-die spouse. Because these assets are not in the estate of the second-to-die spouse, they are valued as of the date they were bought by the trust or transferred into the trust. Thereby, the beneficiary receiving assets from the family trust of a bypass trust is more likely to incur income or capital gains repercussions.

One possible solution for people with a bypass trust is for the second surviving spouse to withdraw funds from the trust to the extent permitted by the trust. Then the assets would be in the estate of the surviving spouse and could receive the stepped-up basis at the time of the second spouse's death.

With portability, the need for a bypass trust appears to be diminished for married couples with combined assets under the federal estate tax exemption amount, which is currently at $10.68 million in states (such as Virginia) which have no estate tax or inheritance tax.

Portability does not remove the need for a bypass or credit shelter trust altogether. However, given the recent changes in capital gains tax brackets and percentage tax rates (15 percent or 20 percent) and possible income tax consequences, the capitals gains tax has become a consideration in deciding to use a bypass trust. When factoring in the variables of the different estate, inheritance and income tax structures in each state and adding the 3.8 percent Obamacare tax on higher income individuals, the possibility exists that higher income beneficiaries may incur combined taxes near 40 percent in highly appreciated assets.
GST transfers further complicate the decision making process. If a deceased spouse leaves behind assets to the surviving spouse outright, relying totally on portability, then the deceased spouse's estate could not take full advantage of both individual's GST exemptions since portability does not apply to GST.

Use of a bypass trust in all family situations should not the norm, but rather, the efficacy of a bypass trust or a standard will-based estate plan should be determined by a case-by-case analysis.

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Getting More Out of Trusts: The Total Return Unitrust

By John Bryan

Trusts have become a basic tool in estate planning. Virtually every trust provides for the distribution of income to the current beneficiary, either mandatory or in the trustee's discretion. The reasons for this vary. In a trust for a surviving spouse (marital trust), distribution of income is required to qualify for the marital deduction, and distributions generally carry out trust income to the beneficiary, thus are subject to less punitive income tax rates. But for most clients, income is intended to provide a source of regular funds to the beneficiary, particularly where the beneficiary is the surviving spouse. For many clients, however, the significant decline in interest rates and the limited returns generated by fixed income investments generally, the last 15 years has made the benefit for many trusts modest at best.

A simple example illustrates the shift. Assume a marital trust under a will with $1 million conservatively invested in 10 year treasury notes:

- In January 1990, the rate for these notes was 8.21 percent, generating annual pre-tax income of roughly $82,000 for the surviving spouse.
- In January 2014, the rate for these notes was 2.85 percent, generating annual pre-tax income of roughly $28,000 for the surviving spouse.

This reduction is obviously dramatic and highlights a basic challenge for trustees - how to invest in a way to provide income for the current beneficiary and not abandon some appreciation for the residual beneficiaries in light of their fiduciary obligations to each. Traditionally, trustees have responded by taking a conservative approach when investing trust assets, driven by concerns that more aggressive investments to generate higher returns pose greater risks and exposure to fiduciary claims by current and/or residual beneficiaries.

The evolution in total return and modern portfolio theory has led to a new approach to accommodate competing responsibilities of trustees and grantors of trusts, giving them the ability to reclassify income and principal to adjust payments to the current income beneficiary.

Under Virginia's version of the concept, the trustees of a trust (generally those who are not "interested trustees," but in certain cases, interested trustees can elect to convert) have the ability to convert a trust which provides for payment of income to a beneficiary to a total return unitrust. In a total return unitrust, the amount payable to the beneficiary is based on a percentage of the fair market value of the trust at the time, rather than the income that those assets generate. Moreover, clients creating trusts have the ability to either establish or authorize use of total return unitrusts at the time of creation (or amendment) of their trusts.

The permissible range for the unitrust amount in Virginia is 3 percent to 5 percent of the fair market value of the trust assets. This range dovetails with certain IRS rules for how income can be defined for federal income tax purposes

The ability to either convert a trust to a total return unitrust or build it into new or existing trusts can be a useful tool that many clients will find appealing if they – as grantor or trustees – want to offer a more meaningful current benefit to income beneficiaries under their trusts.

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Estate Planning for Your Eighteen Year Old: What You Need to Do Now May Surprise You

By Lauren Keenan Rote

If your child is turning 18, you may find yourself wondering where the time went. Their estate planning needs are probably the last thing on your mind (or theirs) as they prepare to enter adulthood. In fact, if you're like most parents, you're probably mentally preparing yourself to drop them off at the college of their choice and trying to enjoy the last bit of time you have with them before you're an empty-nester. Or if college isn't part of your child's plan, you may be helping them settle into their first full-time job or apartment hunt for their first place.

For most parents (and their 18 year-old children), estate planning isn't something they are thinking about. You may think because your child doesn't own anything of value yet and may not have children of their own, why would they need an estate plan? The answer is quite simple. Once your child turns 18, they are no longer a minor in the eyes of the law--they are now adults. Becoming an adult comes with certain privacy rights and independence under the law.

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For example, if your child is away at school or on the job and falls ill, you may assume you would be contacted and able to direct their care, as you always have done. After all, to you they are still your little girl or little boy. Then, you may be surprised to find out that may not be the case. An 18 year-old has rights under HIPAA (Health Insurance Portability and Accountability Act) and medical professionals will require a release to be signed by your child before sharing their health care information or records with you. The same rule applies to mental health records, which may be particularly difficult to access without your child's permission.

In the event your child is incapacitated, even temporarily, he or she will be unable to consent to you accessing their vital health records or authorize you to make decisions on their behalf. In the absence of such an authorization or release, you'll likely find you are unable to act on their behalf and that court intervention is required for you to do so. In absence of the estate planning documents described below, you would need to file a petition with a court to be named your child's legal guardian. This process can be time consuming, emotionally draining and expensive. For these reasons, it is a best practice to have your child put their wishes into written form as soon as they reach the age of majority (which is 18 years old in most states).

There are two critical documents that any adult over the age of 18 should have:

1. **Medical Power of Attorney/Advance Directive with a HIPAA** provision – This document appoints an "agent" or "agents" to make health care decisions, including end-of-life care decisions on your child's behalf. It also offers direction as to the decisions they would like their agent to make. This document should include a HIPAA release authorizing the agent to access important health records and may also incorporate provisions regarding mental health care.

2. **General Durable Power of Attorney** – This document is similar to the Health Care Power of Attorney in that it appoints an "agent" or "agents" to make decisions on behalf of your child. However, this document relates to your child's financial assets. This may include granting the agent(s) access to bank accounts, scholarship funds from school, rental agreements or other similar accounts.

The Durable Power of Attorney can be a) springing or b) non-springing. A "springing" power of attorney is one in which the agent(s) have no authority to act unless and until the principal (your child) is incapacitated. A "non-springing" power of attorney is one in which the agents' authority to act is immediate upon execution of the document. Both versions have benefits. A springing document may be advisable in situations where parents still intend to handle many financial matters on behalf of their adult child.

In summary, there is no time like the present to plan for the future. Doing so with your kids might seem awkward at first, but broaching the subject is a great way to acknowledge their new-found adulthood and reinforce their independence.

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