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Trusts and Estates

# Advantages of Using the Post-Portability Bypass Trust

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A "bypass trust" is a common estate planning tool that has traditionally been used as a way to shelter assets from the federal estate tax for the benefit of a married couple's heirs. A bypass trust (also sometimes referred to as a "family trust," "credit shelter trust" or "nonmarital trust"), which is created at the death of the first spouse to die under a will or revocable trust, is funded with the amount of assets from a decedent's estate that is exempt from the federal estate tax. Under current law, the federal estate tax exemption amount (also known as the "unified credit exemption equivalent" or "applicable exclusion amount") is \$5.45 million, so that assets equal in value to up to that amount in a decedent's estate can be used to fund the bypass trust, and those assets would not be subject to the federal estate tax (currently a 40 percent tax) in the decedent's estate.

The mere utilization of a bypass trust is not what causes assets to escape the federal estate tax. If the same amount of assets would instead be left outright to a decedent's heirs, there would still not be any federal estate tax in the decedent's estate on assets up to the \$5.45 million exemption amount. The reason the trust serves as a so called credit-shelter is because of the ability to set aside assets for the benefit of the surviving spouse, but shelter them from being added to the surviving spouse's taxable estate at death.

Historically, bypass trusts had been widely used for married couples because of the "use it or lose it" feature of prior law for the exemption from the federal estate tax. Even though assets passing to a U.S. citizen surviving spouse, regardless of the amount of assets, are not subject to the federal estate tax at the first spouse's death because of the unlimited marital deduction, bypass trusts had long been used so that both spouses could utilize their exemption amounts. If a bypass trust was not utilized in the first spouse's estate, the first spouse's exemption amount was essentially wasted. For example, if a husband died with a net worth of \$3 million, and he left these assets outright to his wife at death, there would have been no federal estate tax at the husband's death because of the unlimited marital deduction. However, when the wife subsequently died, her taxable estate would consist of the \$3 million of assets that she received outright from her husband (plus any growth on those assets), plus another \$3.5 million of assets she had already owned in her own name (i.e., \$6.5 million in total). If the wife died in the year 2009, when the exemption amount was

\$3.5 million, she would only have been able to utilize her own exemption amount (i.e., \$3.5 million) for assets passing to her heirs, but would be taxed on the remaining \$3 million amount that she received from her husband (since the husband's estate did not utilize his exemption by segregating the assets in trust, it was, in effect, wasted). Had the husband instead created a bypass trust under his will, his estate tax exemption would have been utilized, and on the wife's subsequent death, those assets would not have been includible in her taxable estate. She could then use her own exemption for her remaining assets owned outside of the trust, so that both husband's and wife's exemptions were used. This was the "use it or lose it" nature of the exemption under prior law. It was like a big coupon that expired at death.

Under current law, there is a new "portability" concept that to a large degree replaces the prior "use it or lose it" structure of the federal estate tax exemption rules. This change was made by the 2013 enactment of American Taxpayer Relief Act (ATRA), which created a new system allowing the estate tax exemption to be portable between spouses. Under ATRA, a surviving spouse, in many (but not all) circumstances may utilize the first spouse's unused federal estate tax exemption amount without the need to use a bypass trust. Now, if a husband leaves all of his assets outright to his wife at a time when the exemption amount is \$5.45 million, the portion of the exemption that is not used by the husband (because of the marital deduction) becomes portable to the wife so that when she later dies, if she remains eligible to benefit from the portability regime, she will have \$10.9 million in available exemption, which her estate can then allocate to her assets and the assets that she inherited outright from her husband.

It is essential to be mindful that to use portability, after the death of the first spouse, an election must be timely made by filing a properly completed IRS Form 706 (federal estate tax return). Since portability has come into law, many now question why a married couple should still bother establishing a bypass trust at the death of the first spouse.

Even with portability, there remain significant advantages to using a bypass trust in the estate of the first spouse. If a bypass trust is utilized, then not only is the funding amount exempt from the federal estate tax, but any appreciation or growth on those assets will also be shielded from the federal estate tax in the surviving spouse's estate. Let's say that a bypass trust is funded with \$5 million of assets and those assets grow at a rate of 6 percent a year for 10 years. That means that after 10 years, there will be almost \$4 million in growth in the bypass trust, which will escape the estate tax in the surviving spouse's estate. Had the spouse received that \$5 million as an outright distribution, rather than through the trust structure, the growth would not have been sheltered from the spouse's taxable estate. At the 40 percent tax rate, that affords a potential tax savings of \$1.6 million.

For married couples with a combined net worth below the \$10.9 million combined exemption amount, who may consider relying on portability, it is important to note that there is always a possibility that the exemption amount may be reduced. Although the exemption is at \$5.45 million per individual today, in recent history, it has been much lower. Both Hillary Clinton and Bernie Sanders have proposed decreasing the exemption back down to \$3.5 million per person, for example. If that were to happen, a married couple may be more on the cusp of an estate tax than they originally had thought, and creating a bypass trust with the possibility of protecting appreciation may be even more attractive.

Another consideration when relying on portability is that if the surviving spouse remarries and is the survivor of that second marriage, the unused exemption from the first marriage may be lost. Thus, reliance on portability may be a bit of a gamble because of the potential of remarriage, which is, of course, unpredictable.

Even with the portability regime, bypass trusts remain the only method of using the exemption from the generation-skipping transfer (GST) tax of the first spouse to die when the plan is to delay gifts to descendants until the death of the surviving spouse. Unlike the estate tax exemption, the GST tax exemption is not portable, and thus remains "use it or lose it." When planning with a bypass trust, a decedent's GST exemption (currently \$5.45 million) can be allocated to that trust so that its assets may be permanently exempt from the GST tax. Such exemption avoids the imposition of a GST tax (at a rate equal to the highest estate tax rate) when the assets subsequently pass to grandchildren or younger generations in the future. In the case of a married couple, unlike the federal estate tax exemption, if the GST exemption is not allocated at the first death, then it is wasted and it will not be portable to the surviving spouse. The surviving spouse would only be entitled to use his or her own GST exemption. For couples with combined assets in excess of \$5.45 million (or even a lower amount if we take into account growth after the first death), this may be a compelling reason to utilize the bypass trust structure.

When considering the tax benefits of a bypass trust, the estate tax savings must be carefully weighed against any potential capital gains taxes with respect to growth on the assets in that trust because of the basis treatment. When an individual dies, the assets in that individual's estate will receive a step up in basis (i.e., the tax basis or cost basis in those assets will be revalued based on the date of death values rather than when the assets were originally purchased). Thus, any assets that are used to fund the bypass trust will receive a step up in basis at the death of the first spouse. However, at the surviving spouse's death, the assets in the bypass trust will not receive a second step up in basis to the extent that there was growth in the assets after the first spouse's death. Had the assets been left outright to the surviving spouse, rather than in a bypass trust structure, the assets would have received a second step up in basis in the survivor's estate. If there was significant growth in the assets after the first death, the potential capital gains tax when a future sale of the assets occurs will need to be carefully weighed against the potential estate tax savings. For larger estates, the federal estate tax savings (based on a tax of 40 percent) is generally greater than the capital gains tax savings (based on a tax ranging from 20 percent to 24 percent). The loss in the second basis step up is more of a concern for estates with combined assets under the estate tax exemption where funds would have passed to heirs without estate tax anyway. That being said, there may be ways to manage this concern. One solution may be for the surviving spouse to buy assets from the bypass trust in exchange for a promissory note so that any future appreciation in those assets will be in the surviving spouse's estate and would receive a second stepped-up basis.

Setting aside potential tax benefits, there are numerous nontax advantages for leaving funds in a bypass trust for a surviving spouse. Some of these benefits include: (1) protection from the possibility of diversion of family assets upon a remarriage by the surviving spouse; (2) allowing someone other than (or in addition to) the spouse be involved with (or have control over) investing the assets and making decisions about distributions; (3) creating a structure for an inheritance that separates the inherited assets from other assets, thereby helping the

spouse preserve the assets on a psychological level; and (4) creating an effective legal shield to protect the assets from a spouse's creditors. •

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