



BYPASS TRUST PLANNING IN A HIGH EXEMPTION ENVIRONMENT

After President Trump signed the tax reform bill (the “Tax Bill”) into law at the end of 2017, many clients may have been lulled into a false sense that no update to their existing estate plan is required given the increased estate and gift tax exemption amount. In fact, the Tax Bill introduces uncertainty that should be considered by virtually all of our clients.

I. What Does the Tax Bill Do to the Estate, Gift, and GST Tax Exemption?

The Tax Bill doubles the estate, gift, and generation-skipping transfer (“GST”) tax exemptions from \$5 million adjusted for inflation (\$5.49 million for 2017) to \$10 million adjusted for inflation (approximately \$11.18 million for 2018). The increased estate, gift, and GST tax exemptions are not permanent. Instead, unless Congress affirmatively acts to make the increases permanent or to extend them, they are scheduled to expire on December 31, 2025. After that time, the estate, gift, and GST tax exemption amounts will return to pre-2018 levels (\$5 million adjusted for inflation). If this sounds familiar, it is. At the end of 2012, when the estate, gift, and GST tax exemptions were scheduled to be reduced from \$5 million to \$1 million, Congress passed legislation making the \$5 million exemptions permanent—or as permanent as tax legislation can be. There is no guarantee Congress will extend or make the \$10 million exemptions permanent at the end of 2025 as it did with the \$5 million exemptions in 2012. House Republicans recently passed a bill that would make the new exemption amount permanent, but it is widely agreed that this measure will not receive the votes necessary to pass the Senate. In fact, although there is hardly a consensus, there are more predictions this time around that the exemption amount could revert to 2017 levels.

II. How Is a Typical Bypass Trust Plan Structured?

A. Benefits of a Bypass Trust

To understand why the Tax Bill impacts so many clients, a quick review of basic estate planning structures is needed. A common plan for a married couple provides that, at the first spouse’s death, the decedent’s estate tax exemption amount passes to a “Bypass Trust” for the benefit of the surviving spouse, preserving the first spouse’s estate tax exemption. Assets held in the Bypass Trust at the second spouse’s death will not be included in such spouse’s estate for federal estate tax purposes, and will pass to the children or other individuals free of estate and gift tax, taking full advantage of both the first and second spouse’s exemption amounts.

B. Potential Drawbacks of the Typical Bypass Trust

Under current law, the basis of an asset held outright by the surviving spouse will be “stepped-up”

to the fair market value of the asset at the surviving spouse's death. Therefore, a potential downside to the typical Bypass Trust plan is that assets held in the Bypass Trust at the surviving spouse's death will not receive a step-up in basis for federal income tax purposes. In some circumstances, clients who are less concerned about estate tax than about losing the step-up in basis at the surviving spouse's death may prefer a plan that ensures the clients' assets will receive a basis step-up at the second death.

Another downside to a Bypass Trust plan is that it requires certain administrative steps to be taken on the part of the surviving spouse, such as maintaining separate bank accounts for the Bypass Trust and filing a separate income tax return for the Bypass Trust. A Bypass Trust may not be administered as the surviving spouse's checkbook—it is a real trust and must be administered as such. Thus, flexibility is lost and administrative formalities must be maintained.

III. Examples of the Tax Bill's Impact on a Client's Bypass Trust Estate Plan

A. Married Couple, \$8 Million Estate

Consider a married couple, the Smiths, with a collective \$8 million estate consisting entirely of community property. The Smiths currently have a typical Bypass Trust estate plan. If the first spouse dies in 2018, all of the first spouse's share of the community estate (\$4 million) will pass to a Bypass Trust. The second spouse dies in 2022. During that time, the assets held in the Bypass Trust have appreciated from \$4 million to \$6 million. The surviving spouse's share of the community property has also appreciated to \$6 million. No estate tax is due on the surviving spouse's death because the assets held outright by the survivor (\$6 million) are valued below the current \$11.18 million estate tax exemption. The assets held outright by the surviving spouse receive a step-up in basis at the survivor's death so that, if the beneficiaries sell the survivor's property soon after the survivor's death, there will be no taxable capital gain. However, although the assets in the Bypass Trust received a basis step-up at the first spouse's death, the assets held in the Bypass Trust do not receive a basis step-up on the second death. When the beneficiaries sell the assets in the Bypass Trust, they will realize a capital gain of \$2 million on the appreciation incurred between the first spouse's death and the survivor's death.

Had the first spouse left his entire estate outright to the survivor, the survivor would have died with a \$12 million estate, which likely would be less than the survivor's estate tax exemption, assuming adjustments to the estate tax exemption for inflation increase it to at least \$12 million, and the entire \$12 million would have received a basis step-up on the survivor's death. As a result, this same couple could have achieved substantial income tax benefits if the first spouse's estate, instead of passing to a Bypass Trust, had instead passed entirely to the surviving spouse outright, or to a marital deduction trust for the surviving spouse.

B. Married Couple, \$18 Million Estate

Consider the Joneses, who have a community estate of \$18 million and a typical Bypass Trust plan. Similar to the Smiths, their community estate increases by \$4 million between the first spouse's death in 2018 and the death of the survivor in 2022. Also similar to the Smiths, the Jones family could have saved substantial income tax by instead leaving the entire estate of the first spouse outright to the survivor. However, unlike the Smiths, if the entire estate of the first spouse is left outright to the survivor, the estate of the survivor, at \$22 million, will be well over the survivor's estate tax exemption of approximately \$12 million unless further action is taken to preserve the first spouse's estate tax exemption (as described in Section IV below).

As illustrated by the Jones example, the most tax-efficient plan for a couple with an estate close to the \$22 million amount will depend on the marginal income and estate tax rates applicable, the ability to preserve the first spouse's estate tax exemption, and the amount of expected appreciation in the assets between the first and second deaths.

IV. Alternatives to Consider

In view of the much higher exemption amount, clients with assets that fall below \$22 million per couple should question whether they really need a Bypass Trust, or if an alternative plan may be more beneficial. On the other hand, the same clients must also anticipate the real possibility that the exemption amounts will be reduced back to pre-2018 levels. There is no one-size-fits-all plan, and flexibility may now be a paramount concern. The following are typical, though not exhaustive, examples of estate plans that may be appropriate for clients under the Tax Bill.

A. Bypass Trust Plan

A Bypass Trust plan may continue to be appropriate, even for a couple with an estate worth less than \$22 million. In addition to potential estate tax savings, a Bypass Trust plan continues to offer the surviving spouse creditor protection with respect to the assets held in the Bypass Trust. If clients are older and close in age, or if a client's estate does not contain assets that are likely to appreciate significantly between the first and second deaths, the income tax savings of an alternative to a Bypass Trust plan may be minimal. Also, if the clients are likely to survive until 2026 when the exemption amount will decrease to \$5 million as adjusted for inflation, absent Congressional action, a Bypass Trust plan may continue to be appropriate. Many estate planners are now including a formula testamentary general power of appointment in the traditional Bypass Trust plan. This alternative is discussed in more detail below.

B. Formula General Power of Appointment Plan

Another alternative that deserves mention is the use of a formula general power of appointment in a Bypass Trust. The structure would include a typical Bypass Trust, but the trust would also confer upon

the surviving spouse a testamentary general power of appointment over the trust assets to the greatest extent possible without generating an estate tax in the surviving spouse's estate. A testamentary general power of appointment gives the surviving spouse the power to appoint the trust assets at death to the surviving spouse, the surviving spouse's creditors, the surviving spouse's estate, or the creditors of the surviving spouse's estate. Property subject to a general power of appointment is generally included in the taxable estate of the individual holding the power. The assets thus included in the surviving spouse's estate will receive a basis step-up at the survivor's death but will not cause an estate tax to be incurred if the survivor's estate, including the assets held in the Bypass Trust, is less than the survivor's estate tax exemption. In the example of the Smiths with the \$8 million community estate, all of the first spouse's estate would pass to a Bypass Trust. But if estate tax exemptions remain at current levels, at the survivor's death the formula general power of appointment would cover all of the Bypass Trust assets, resulting in estate tax inclusion of the entire Bypass Trust without estate tax and generating an income tax basis step-up for all of the Bypass Trust assets.

C. Portability Plan

Alternatively, the first spouse to die could leave his or her entire estate outright to the surviving spouse or to a marital deduction trust that is included in the surviving spouse's estate for federal estate tax purposes. Even though no estate tax will be due on the first death because of the marital deduction, the surviving spouse can file an estate tax return for the first spouse, electing "portability," meaning that any of the first spouse's unused estate tax exemption will be added to the estate tax exemption amount of the second spouse on his or her subsequent death. If portability is not elected, the first spouse's unused exemption amount will be lost. The advantage of a plan based on electing portability is that on the second death, all of the assets will receive a basis step-up, achieving income tax savings for the beneficiaries. The disadvantage of this plan is that it requires the survivor to remember to file an estate tax return electing portability. Otherwise, the first spouse's unused exemption will be lost. Also, even if the surviving spouse elects portability, the first spouse's unused exemption may be lost under certain circumstances if the surviving spouse remarries.

D. Disclaimer Plan

Another alternative estate plan is to bequeath all of the first spouse's estate to the surviving spouse, with a provision in the plan stating that if the surviving spouse "disclaims" (*i.e.*, refuses to accept) the first spouse's estate tax exemption amount, it will pass to a Bypass Trust. If the surviving spouse disclaims the exemption amount, the exemption amount will pass to the Bypass Trust, taking advantage of the first spouse's estate tax exemption. This allows the surviving spouse to consult a tax advisor at the first spouse's death to determine whether a Bypass Trust would be advantageous for the surviving spouse. For example, if the estate tax exemption has decreased to pre-2018 amounts or the surviving spouse desires creditor protection, the surviving spouse might determine to disclaim the outright bequest into a Bypass Trust. On the other hand, the surviving spouse might determine that the various advantages of an outright

bequest outweigh those of the Bypass Trust. The primary disadvantage of a disclaimer plan is that it requires action on the part of the surviving spouse on the first spouse's death. At the first death, the surviving spouse will need to consult a tax advisor and make what is called a "qualified disclaimer" of the exemption amount. If the surviving spouse does not do this within nine months after the first spouse's death, the ability to disclaim without making a taxable gift to the Bypass Trust will be lost.

V. CONCLUSION

The alternative estate plans described above are by no means exhaustive. A client's estate plan can be tailored to meet a particular client's circumstances and needs, whether that be estate tax planning, income tax planning, succession planning, or creditor protection planning. Clients are encouraged to consult their tax adviser and review their existing estate plan to assess which plan is appropriate for a client's particular circumstances.

If you have additional questions, please do not hesitate to contact the Thompson & Knight attorney with whom you regularly work or one of the attorneys listed below.

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