



Is a Bypass Trust Still Necessary?

By Jim Weil, CIMA®, CFP®

Before the 2012 tax law change, traditional estate planning for affluent estates often called for a bypass trust (also known as a credit-sheltered trust, a family trust, or a living trust). The theory was to maximize the federal estate-tax exemption, which used to be as low as \$600,000 back in 1997 but had risen to \$3.5 million by 2009. A bypass trust allowed each spouse to shelter as much as \$3.5 million in order to eliminate estate taxes on a transfer to the next generation, for a total of up to \$7 million per couple with proper planning.

The American Taxpayer Relief Act of 2012 changed the rules as well as the potential utility of such trusts. Two significant changes in the Act of 2012 are (1) the federal estate-tax exemption is \$5.25 million per person beginning in 2013 and indexed for inflation; and (2) the exemption is now portable, which means that if you are married at the time of your death, your spouse is entitled to any remainder of your exemption that has not been utilized.

A bypass trust can still make sense depending on your overall estate-planning goals and the value of your taxable estate. However, certain consequences of these two changes may provide cause to review your plans.


First, the typical bypass trust generally is subject to restrictions such as the “ascertainable standard,” which states that the beneficiary, typically the surviving spouse, may have the trust income plus additional amounts for “health or maintenance in reasonable comfort.” Based on the size of your estate, the increased exemption amount, and the exemption portability, does it still make sense to impose these restrictions on the surviving spouse? In addition to the restrictions, certain maintenance costs also need to be considered, such as the

trust administration and a separate tax return for the trust itself.

Second, each individual state may have its own estate-tax exemption that may not match the federal structure, creating the potential to accelerate taxes. If you are an Illinois resident, for example, the state of Illinois has decoupled from the federal estate-tax system and has a \$4 million estate-tax exemption beginning in 2013 that is not indexed for inflation. Most estate plans, if not updated to anticipate this decoupling, fully fund the maximum federal exemption amount of \$5.25 million, which then may subject the estate to a tax of more than \$350,000 when the first spouse dies. Most estate-planning clients, particularly those with estates valued at less than \$10 million, prefer to defer all estate taxes until the last spouse dies.

Additional considerations that may suggest continued value of the bypass trust might include the following: (1) to provide a trustee to manage or monitor the assets for the surviving spouse, (2) to ensure certain estate-

planning goals are met such as providing for children from different marriages, and (3) to maximize the step-up in cost basis for highly appreciated assets, which could minimize future capital gains taxes. Depending on a person’s particular goals, other considerations may come into play as well.

This article is not intended to be an exhaustive analysis and recognizes that each estate plan is unique to each family. It may, however, provoke a review of your plan, which is important because many estate plans are infrequently or never reviewed. A regular review of your estate and financial plan, particularly when tax laws change, will ensure the plan continues to meet your objectives. 

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