

# BYPASS TRUSTS

## OVERVIEW

A bypass trust, also known as a credit shelter trust, is an estate planning tool used to transfer assets in order to minimize a potential estate tax liability. It is an irrevocable trust and most commonly used when one spouse passes away and he or she wants to use the available estate tax exemption. Those assets will transfer estate-tax free upon the death of the surviving spouse. For those assets in a bypass trust, the surviving spouse has access to its income as well as its principal, if needed, for the duration of his or her lifetime. By leaving property to each other in bypass trust form, a couple can guarantee that the property will only be subject to estate tax once between the two of them.

## HOW THEY WORK

### TRUST PARTIES

There are three main parties to a trust, although the same person can serve all three roles:

- Grantor – Also called the settlor, donor, or trustor, this is the person who establishes and funds the trust. In the case of a bypass trust, the grantor is the first spouse to die.
- Trustee – The legal owners of the trust's property, in charge of administering, preserving, and distributing trust assets in accordance with the trust documents.
- Beneficiary – The surviving spouse is able to withdraw the income and in certain cases, have access to the principal. A child, charity, or any other entity which will inherit the trust's assets are the ultimate beneficiary of a bypass trust.

### ESTATE TAX

The estate tax is levied on assets left to heirs upon one's death over and above the estate tax exemption. The exception to this rule is the unlimited marital deduction which allows the decedent spouse to pass an unlimited amount of assets to the surviving spouse free of estate taxes. However, upon the surviving spouse's death, the remaining assets will be entitled to only one estate tax exemption. For example, in 2015, the estate tax exemption is \$5.43 million. If a couple has an estate worth \$12 million, and one of the spouses dies, they can leave the entire amount to the surviving spouse without incurring any estate taxes. However, upon the second spouse's death, the amount over the estate tax exemption (\$12 million minus \$5.43 million) will be taxed.

## **A/B TRUST**

The use of a bypass trust effectively doubles the amount of the estate tax exemption for a married couple. Upon the death of the first spouse, an amount equal to the current estate tax exemption amount (\$5.43 million in 2015) is placed into a trust. Its income can be used to support the surviving spouse, but will ultimately pass to designated beneficiaries. Upon the death of the second spouse, this amount will not be taxed for estate tax purposes. In the example of the \$12 million estate, \$5.43 million dollars will be placed into a “B” or “decedent’s” trust upon the death of the first spouse. This amount will never be subject to estate taxes. The remaining \$6.88 million is then placed into an “A” or “survivor’s” trust which the surviving spouse will have full control over. Upon the surviving spouse’s death, any remaining assets are then entitled to their own estate tax exemption. With the use of a bypass trust, the couple in the example will not be subject to any estate taxes in the bypass trust.

## **TRUST INCOME**

The primary limitation with the use of a bypass trust is that the surviving spouse has limited control over those trust assets. However, they are entitled to the trust income and access to trust principal for specific reasons. The surviving spouse has the right to withdraw principal to provide for his health, education, maintenance, or support (HEMS), if the amount of annual income from the trust is insufficient to cover such expenses.

## **PROBATE**

Trust assets are not subject to the probate process, which allows heirs to save considerable estate settlement and probate costs. These include the attorney and court costs associated with taking inventory and distributing trust assets. In addition, distribution of trust assets will most likely occur quicker if it is able to bypass the probate process.

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