



TAX PLANNING IN REVOCABLE TRUSTS

Bypass Trusts and Marital Deduction Trusts

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1. TRANSFER TAXES

1.1 **Overview:** This memo explains how a trust can save transfer taxes for an estate which is potentially subject to the federal gift, estate, and generation-skipping taxes. This memo focuses on planning for a married couple whose combined estate exceeds the “applicable exclusion” for federal gift and estate taxes, which is \$2,000,000 in 2008¹ under current law. The concepts discussed here also apply to unmarried couples except with respect to the marital deduction². Stated briefly, transfer taxes are saved by allocating assets into special irrevocable subtrusts upon the death of each spouse. Because this subject is complicated, I suggest you read this memo twice, and I do not recommend it for bedtime reading (except as a cure for insomnia).

1.2 **Federal Transfer Taxes:** Congress has imposed taxes on three types of transfers: lifetime gifts; transfers from decedents' estates; and generation-skipping transfers.

(a) A *gift* is a lifetime transfer of any asset for less than its fair market value. A transfer from a decedent's *estate* includes all assets which pass from a decedent by reason of death, including transfers under a will, a revocable trust, insurance policies³ and other death benefits, and property interests which pass by right of survivorship.

(1) Gift and estate taxes are essentially the same tax, since the same tables are used, and the applicable exclusion applies to both taxes.¹ After the applicable exclusion has been used up, the tax rate is 45% (in 2008).

(2) Everyone can make gifts of up to \$12,000 per recipient per year without having to use up the gift and estate tax exclusion. Certain payments of tuition and health care costs can also qualify as gifts which are exempt from the gift tax.

(3) Gifts to spouses⁴ and charities are also deductible for gift tax purposes.

(4) For estate tax purposes, the net value of all assets owned by the decedent is taxable. Funeral expenses, debts (including mortgages), estate administration expenses, and certain other expenses are allowed as deductions in calculating the net value of the estate.

¹ Internal Revenue Code § 2010(c) provides for an “applicable exclusion”, which is the cumulative amount that can pass free of gift and/or estate tax. This is sometimes called “the exemption equivalent of the Unified Credit”. The applicable exclusion has been, is and will be: \$625,000 in 1998; \$650,000 in 1999; \$675,000 in 2000 and 2001; \$1,000,000 in 2002 and 2003; \$1,500,000 in 2004 and 2005; \$2,000,000 in 2006, 2007, and 2008, \$3,500,000 in 2009; unlimited in 2010; and \$1,000,000 in 2011 and beyond.

² Any two or more individuals can preserve the applicable exclusion using an irrevocable bypass trust (often referred to as the “Credit-Shelter Trust”, “Exclusion Trust”, or “Exemption Trust”) for the benefit of the survivor(s) and subsequent beneficiaries; however, unless the trust is used by a married couple, their will be no marital deduction to eliminate the estate tax. As to unmarried persons, when one of the settlors dies, an estate tax will be imposed on that settlor’s taxable estate to the extent it exceeds that Settlor’s unused applicable exclusion.

³ Life insurance proceeds are not usually subject to the federal income tax, but they are usually taxable for purposes of the federal gift, estate, and generation-skipping transfer taxes.

⁴ Special rules apply to spouses who are not U.S. citizens.



(b) A *generation-skipping transfer* is a transfer which skips a generation (such as a transfer to a grandchild or great-grandchild) and can occur various ways, including as a gift, as a transfer from a decedent's estate, or as a distribution from a trust.

(1) The generation-skipping transfer tax ("GST Tax") is imposed when a transfer skips a generation, such as a lifetime gift or an estate distribution to a grandchild or to someone from an even younger generation. The recipient is referred to as a "skip person".

(2) The GST Tax is imposed at the highest estate tax rate, currently 45%⁵, and it applies in addition to any gift or estate tax due. Each person has a "GST exemption" of \$2,000,000⁶, and transfers beyond that amount should usually not be made to skip persons because the estate tax is less burdensome than the GST Tax.

1.3 Nevada Law: Nevada has no gift, estate, or generation-skipping tax laws which impose a Nevada transfer tax, but Nevada does collect part of the federal estate and generation-skipping taxes. In 2005, the federal transfer-tax credit was replaced with a deduction, but the Nevada Constitution permits an estate tax "only to the extent of any credit allowed by federal law"⁷, which means that Nevada's share of the tax has been eliminated.

2. BYPASS TRUST PLANNING

2.1 Generally: The value of assets you own when you die is included in your estate for estate-tax purposes. Sometimes those assets are passed along to other beneficiaries who have estates of their own, and that can push the beneficiaries' estates into higher estate-tax brackets. A "bypass trust" is used to give benefits to one or more beneficiaries without giving them enough rights of ownership to require taxation of the trust assets in the beneficiaries' estates. A bypass trust can also qualify as a "spendthrift trust" which is not subject to the claims of creditors, including judgment creditors, which is useful even when transfer taxes are not a concern.

2.2 Maximum Benefits: The Internal Revenue Code permits a beneficiary to receive significant benefits from a trust without causing the trust or its assets to be considered part of the beneficiary's estate.

(a) Unless the assets were contributed by the beneficiary, the assets will not be considered part of the beneficiary's taxable estate if even the beneficiary has the right to:

- * Receive all trust income;
- * Receive payments from trust principal for support, health, education, and maintenance;
- * Withdraw 5% of principal per year;
- * Direct distributions of the principal during life (to recipients other than the beneficiary and the beneficiary's creditors);
- * Direct distributions of the principal after death (to recipients other than the beneficiary's estate or creditors); and
- * Act as a trustee.

⁵ The highest rate applicable for the gift and estate tax is: 50% in 2002; 49% in 2003; 48% in 2004; 47% in 2005; 46% in 2006; 45% in 2007, 2008, and 2009; 0% in 2010; and 55% in 2011 and beyond.

⁶ The GST exemption was \$1,100,000 in 2002 and was \$1,120,000 in 2003. In 2004, it became the same as the "applicable exclusion" for estate tax purposes, which is shown in footnote 1.

⁷ Nevada Constitution, Art. 10, § 4.



(b) A trust which gives a beneficiary all of those rights is often referred to as a "maximum-benefit bypass trust". A maximum-benefit bypass trust gives most of the flexibility that would come from outright ownership without subjecting the assets to the claims of creditors, the claims of disgruntled spouses in a divorce proceeding, or the obligation to pay federal estate taxes.

2.3 Additional Restrictions: Not every bypass trust needs to be a maximum-benefit trust, and the settlor can restrict or eliminate any or all of the powers. It is common, for example, to eliminate the annual 5% withdrawal right and to limit the power to direct distributions so that the recipients must come from a particular group, such as the settlor's descendants.

2.4 Bypass Trusts for Spouses: For married couples, it is common to want to shelter the predeceased spouse's applicable exclusion¹ while at the same time leaving the surviving spouse with broad benefits and control over the exempt amount. Perhaps the "Credit-Shelter Trust" is the most common form of the bypass trust, and it is discussed more fully in section 3 of this memo.

2.5 Bypass Trusts and the GST Tax: Before the enactment of the generation-skipping transfer tax (GST Tax), there was no restriction on the value of assets that could be allocated to a bypass trust. Under current law, only \$2,000,000⁸ can be allocated to a generation-skipping bypass trust without incurring the GST Tax at one time or another.

(a) For any person who names a grandchild as a beneficiary or as an alternate beneficiary, it is important to allocate as much as possible into a totally exempt trust so that all federal transfer taxes can be avoided.

(b) Although a bypass trust can always save the federal estate tax, it cannot save the GST Tax unless the trust is totally exempt. Unlike the estate tax, the GST Tax has no lower tax brackets, so it is usually unwise and unnecessary to incur a generation-skipping tax.

(c) A trust is made exempt from the GST Tax by filing a federal gift tax return (IRS Form 709) each time transfers are made to it and by declaring on the return that the GST exemption equal to the value of the transfers is allocated to the trust. After death, the GST exemption is claimed on the federal estate tax return (IRS Form 706).

3. APPLICABLE EXCLUSION / MARITAL DEDUCTION PLANNING

3.1 Marital Deduction: Transfers between spouses are entitled to an estate tax deduction. By leaving assets to a surviving spouse, estate taxes can be deferred until the survivor's death. Special rules apply to spouses who are not U.S. citizens, which are discussed in paragraph 3.4(e), below.

3.2 Wasting the Applicable Exclusion: From an estate tax perspective, it is possible to leave too much to the surviving spouse.

(a) If the value of the combined estate of the couple exceeds the applicable exclusion¹, leaving all assets to the surviving spouse can waste the applicable exclusion of the spouse who dies first ("predeceased spouse") and subject more of the surviving spouse's estate to the federal estate tax and to the generation-skipping transfer tax.

⁸ The GST exemption was \$1,100,000 in 2002 and was \$1,120,000 in 2003. See note 6 for the GST exemption and note 5 for the GST rate.



(b) For example, assume a couple has a combined net taxable estate of \$4.0 million, all of which is community property. If the surviving spouse receives everything, there will be no tax when the first spouse dies, but the surviving spouse ends up with a \$4.0 million dollar estate. After applying a single \$2,000,000 exclusion (based on the 2008 applicable exclusion amount), the estate pays a federal estate tax of \$900,000.00. Because everything went outright to the surviving spouse, the predeceased spouse's exclusion was wasted. In contrast, an A/B Trust (discussed below) would create two separate trusts, using the \$2,000,000 applicable exclusion for each spouse, allowing the entire trust estate to pass free of the federal estate tax.

3.3 A/B and A/B/C Trusts: In the example discussed in paragraph 3.2(b), above, the federal estate tax came from unnecessarily wasting the predeceased spouse's exclusion. To utilize the predeceased spouse's exclusion, a revocable trust can be drafted to allocate trust assets into two separate subtrusts: a marital-deduction trust and a credit-shelter bypass trust⁹.

(a) Under the most simple "A/B" trust for a married couple, the exclusion amount is allocated to an irrevocable credit-shelter bypass trust, sometimes called the "Credit-Shelter Trust", the "Exclusion Trust", the "Decedent's Trust", the "Family Trust", or even "Trust B". All assets not allocated to the Credit-Shelter Trust are allocated to the "Survivor's Trust" or "Trust A", which contains the assets the surviving spouse already owns, including separate property and half of the community property. (See Figure 1.)

(b) In more complex trust documents, instead of adding assets to the "Survivor's Trust", a separate "Marital Trust" or "Trust C" is created. (See Figure 2.) There are several forms of a "Marital Trust" which qualify for the marital deduction, one of which is a "QTIP Trust", which is discussed in subsection 3.4, below. A life estate, general power of appointment trust is mentioned in paragraph 3.5(b) below.

(c) The Credit-Shelter Trust is irrevocable, and to avoid taxation when the surviving spouse dies, it is set up as a bypass trust, as discussed in Section 2 of this memo.

(d) Whether the settlors are married or not, the credit-shelter bypass trust can still save estate taxes upon the surviving Settlor's death, but for married couples, no estate tax is due upon the death of the predeceased spouse, regardless of the size of the estate. For unmarried persons¹⁰, the marital deduction does not apply and there cannot be a Marital Trust, and the predeceased spouse's estate will be taxed to the extent it exceeds the applicable exclusion.¹

3.4 QTIP Trusts: A "qualified terminable interest property" trust or "QTIP" trust is a Marital Trust that requires annual income distributions to the surviving spouse, prohibits distributions to anyone other than the spouse during the spouse's lifetime, and *may* reduce or eliminate the spouse's power to change the beneficiaries.

⁹ The explanation allocates assets first to the Credit-Shelter Trust or Exclusion Trust and then to the Survivor's Trust. In reality, it can be done either way, and there can be some technical differences. The division of assets is usually done using complex legal formula clauses, which are characterized as "pecuniary" or "fractional". The various types of allocations and formula clauses are beyond the scope of this memo. In some versions of these documents, the individual trusts are called "Trust A" (which is usually the Survivor's Trust) and "Trust B" (which is usually the exclusion or credit-shelter trust), and the entire arrangement is referred to as an "A/B Trust".

¹⁰ This trust can be used by any two people who wish to allow each other to benefit from their combined estates.



(a) A QTIP trust is appropriate where a settlor with children from a prior marriage wants to provide for the spouse and to defer estate taxes without leaving the surviving spouse the power to eliminate the children.

(b) A QTIP trust can be a spendthrift trust, making the principal exempt from lawsuits and other claims that may arise against the surviving spouse after the death of the predeceased spouse.

(c) Under federal law, a QTIP trust is the only type of trust that can qualify for the marital deduction while at the same time benefitting from the predeceased spouse's GST exemption. Since the Credit-Shelter Trust may have assets with a value equal to the applicable exclusion without incurring an estate tax on the first spouse's death (depending on the year of death), an equivalent amount of the GST exemption can be allocated to that trust, making it fully exempt for GST Tax purposes. After the GST exemption is allocated to the Credit-Shelter Trust, any remaining GST exemption can be allocated to a Marital Trust that qualifies as a QTIP trust if the appropriate election is made.

(d) A QTIP trust does not save or defer any more estate taxes than any other trust or distribution that qualifies for the marital deduction. In fact, if the surviving spouse has a substantial estate, the QTIP trust can incur taxes upon the surviving spouse in higher tax brackets. A QTIP trust can be used: (1) to reduce the surviving spouse's power to dissipate the trust and change its distribution; (2) to shield assets from claims against the surviving spouse; and/or (3) to qualify as an exempt trust for GST Tax purposes.

(e) If the surviving spouse is not a U.S. citizen, no transfers to the surviving spouse qualify for the marital deduction except for transfers to a Marital Trust that qualifies as a "qualified domestic trust" or "QDT" (pronounced "Q-DOT"). A QDT must meet the QTIP trust requirements and must also have a trustee that is a U.S. citizen who must approve all distributions and have authority to withhold any estate tax that becomes due. For large estates, the IRS has adopted rigorous regulations that are intended to insure that it receives all taxes due from a QDT.

3.5 Other Marital Trusts: The QTIP trust is only one type of trust that qualifies for the estate tax marital deduction.

(a) A transfer to a Marital Trust that can be amended and revoked by the surviving spouse will qualify. This would be equivalent to an "A/B Trust", so this option is rarely used.

(b) IRC § 2056(b)(5) describes a trust that provides for income only during life and a general power of appointment at death. Unlike a QTIP trust, a trust established under IRC § 2056(b)(5) can permit the spouse to make gifts of trust assets during the spouse's lifetime.

3.6 Exempt and Nonexempt Trusts: A QTIP trust is essential to preserve the predeceased spouse's exemption for generation skipping transfer tax ("GST Tax") purposes. A married couple with a community property estate with a net value in excess of double the applicable exclusion¹¹ who establish a single trust will

¹¹ If the predeceased spouse's estate (separate property plus half of all community property) has a value less than the applicable exclusion (explained in footnote 1), a QTIP or other marital-deduction trust would not be necessary or helpful to preserve the GST exemption regardless of the value of the surviving spouse's estate.



usually want to provide that when the first spouse dies, the trust will divide into trusts which are exempt and nonexempt for generation skipping purposes.¹²

(a) "Credit-Shelter Trust": This credit-shelter bypass trust will be funded with the amount that can pass tax free because of the applicable exclusion.¹ A corresponding amount of GST exemption will also be allocated to this trust to make it totally tax free for multiple generations.

(b) "Exempt Marital Trust": A marital deduction trust, in the form of a QTIP trust, will be funded with an amount equal to the unused GST exemption. This would usually be equal to the difference between the available GST exemption and the value allocated to the "Credit-Shelter Trust".

(c) "Nonexempt Marital Trust": In order to avoid paying estate taxes when the surviving spouse dies, the balance of the estate must be allocated to a trust which qualifies for the marital deduction. This could be a QTIP trust, but it must be kept separate from the "Exempt Marital Trust" because this portion will not be exempt from the generation skipping transfer tax. The nonexempt assets could also be allocated to the "Survivor's Trust".

(d) Exempt vs. Nonexempt: The provisions of exempt and nonexempt trusts can be the same or similar, but generally, distributions to children will be made from the nonexempt trusts because they will be subject to estate taxes in the children's estate and because distributions to grandchildren or lower generations would incur a generation skipping transfer tax. Distributions to grandchildren and lower generations would normally be made from the exempt trusts since they are not subject to the GST Tax.

4. PAYMENT OF TAXES

4.1 A/B Trusts and A/B/C Trusts are very commonly designed using clauses that are specifically designed to that no tax is due upon the death of the first spouse to die. "Formula clauses" are frequently used so that the applicable exclusion and marital deduction work together to zero out any tax that would otherwise be due when the first spouse dies. Taxes can be triggered upon the first death if assets passing outside the trust plus assets disclaimed by the surviving spouse have a value exceeding the estate tax applicable exclusion. If the gross estate exceeds the applicable exclusion for estate tax, a federal estate tax return (IRS Form 706) must be filed even when no estate tax is due because of applicable credits and deductions.

4.2 If the Marital Trust is designed as a QTIP trust, the marital deduction applies only if the proper QTIP election is made on the deceased spouse's Form 706. If the QTIP election is not properly made, the assets in the Marital Trust will be taxed at the first death (payable nine months after the date of death).

4.3 Upon the surviving spouse's death, the value of the assets in any trust for which the marital deduction was taken will be added to the assets otherwise includible in the survivor's estate for purposes of determining the tax on the survivor's estate. Unless the surviving spouse's will provides otherwise, a QTIP trust is responsible for paying the federal estate tax on the entire estate reduced by the taxes that would be payable on the estate without the QTIP trust. In other words, the QTIP trust pays the estate tax at the highest tax bracket, and it gets the benefit of the applicable exclusion and lower tax brackets only to the extent they are not used by the survivor's other assets. The estate tax triggered by the survivor's death is due nine months after that death.

¹² A detailed outline of the generation-skipping transfer tax is beyond the scope of this memo. Suffice it to say that it is a poor use of the GST exemption to allocate it to a trust that will not be fully exempt from all generation-skipping taxes. A fully exempt bypass trust can last several generations without subjecting the trust to estate taxes (or even creditors' claims for that matter).



5. CONCLUSION

5.1 The creation of several trusts (or subtrusts) upon the first death accomplishes two tax-planning objectives.

(a) First, the use of a marital trust or a trust that is revocable by the surviving spouse can defer the estate tax on the assets of that trust — either all or in part — until the surviving spouse’s death.

(b) Second, the creation of a credit-shelter bypass trust can preserve the applicable exclusion of the first spouse to die.

5.2 If coordinated with generation-skipping planning, the A/B or A/B/C trust can help save taxes in lower generations as well. The division into multiple trusts and the allocation of assets into separate trusts can actually provide an opportunity for further tax and family planning. In addition, there may be asset-protection benefits if the Credit-Shelter Trust and/or the Marital Trust are considered irrevocable spendthrift trust under applicable state law.

5.3 To be effective, the trust must be properly designed and implemented while both spouses are living, and the surviving spouse must, after the first spouse’s death, take steps to divide and allocate the assets between or among the subtrusts as required by the trust instrument.¹³

NOTE: This memo provides general information only and does not contain legal, accounting, or tax advice. For brevity, this memo is oversimplified and should not be relied on for any particular situation. Although this memo may discuss tax issues, this is not a “covered opinion” as defined in Circular 230 issued by the U. S. Treasury Department, and nothing in this memo can be relied upon to avoid any tax penalties.

[END: March 22, 2008]

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¹³ The division and allocation of trust assets is discussed in the memo entitled “Allocating Assets to Subtrusts Upon the First Death”, which is available for download at <http://rushforth.net/pdf/abc-split.pdf>.



Flow-chart Diagrams

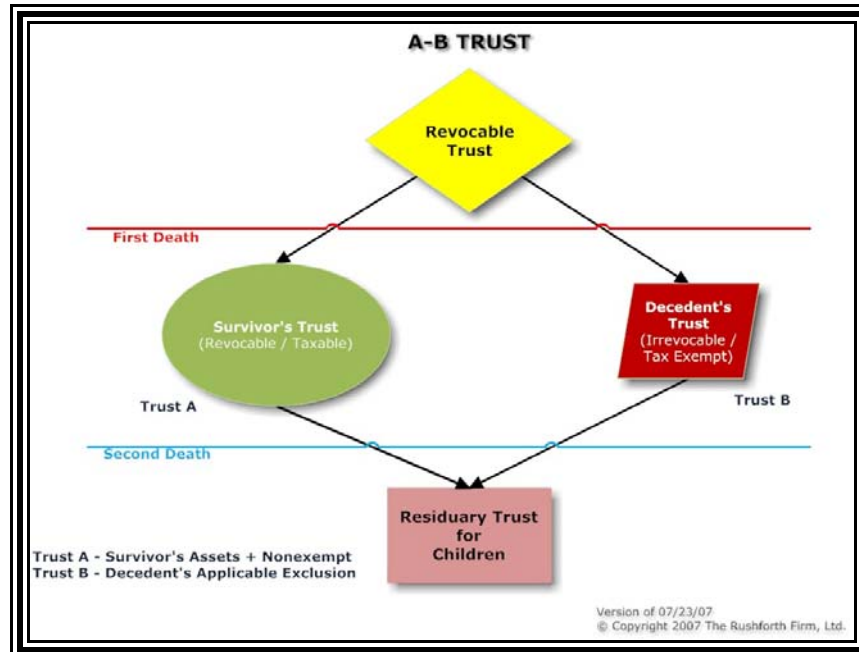


Figure 1: A/B Trust

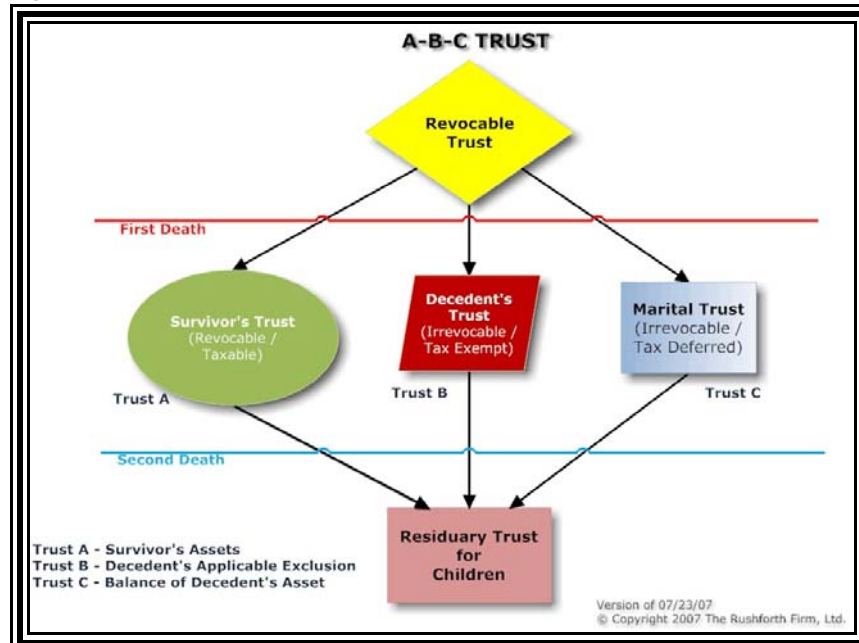


Figure 2: A/B/QTIP Trust