

## Using the Bypass Trust

### The Marital Deduction Creates a False Sense of Security:

Transferring assets to the spouse and heirs is an important estate planning goal for a married couple, especially when trying to reduce federal estate taxes. Ordinarily that is an easy-to-reach goal. Generally, unless your estate exceeds \$2 million you won't owe any federal estate taxes as an individual. Additionally, married couples can pass along an unlimited amount of assets to each other free of "death" taxes. This is known as the marital deduction. Be aware that there are certain limits if the surviving spouse is not a U.S. citizen.

At this point, since the Florida Dental Health Foundation is a charitable organization, I like to point out that in addition to the unlimited marital deduction Uncle Sam also allows an unlimited *estate tax charitable deduction*. Enough commercial!

The marital deduction leads many couples to believe they'll escape federal estate taxes simply by leaving everything to each other at death. Our example shows this is not true.

*Example: consider Dick and Jane, a husband and wife, each with \$1.5 million in assets. When one spouse dies, the survivor can receive all of the deceased spouse's assets without incurring any federal estate tax thanks to the marital deduction. However, the surviving spouse would then have an estate worth \$3 million but still have an individual estate tax exclusion of only \$2 million. The result: That estate will be taxed on the "extra" \$1 million upon the second spouse's death, at a rate of up to 46 percent - potentially a \$460,000 tax bill in this illustration.*

Married couples must plan carefully if they want to retain the maximum amount of assets.

### Bypassing Federal Estate Tax –

One way to protect your assets is by establishing a *bypass trust*. Here's how a bypass trust would work for Dick and Jane in our example. When the first spouse dies, his or her \$1.5 million would be transferred to the bypass trust free of federal estate taxes. Assuming no gain or loss in the value of the second spouse's assets, the surviving spouse's estate would be valued at \$1.5 million upon his or her death – and would not be subject to federal estate taxes because it falls below the \$2 million threshold. As a result, the couple would avoid the \$460,000 tax bill.

### Flexibility of the Bypass Trust

Equally important is a bypass trust's ability to provide for the family. A surviving husband or wife can use the income generated by the assets held in a bypass trust (as well as the principal, in some cases) to meet a variety of living expenses, depending on how the trust is designed. In addition, you can design the trust to transfer assets that remain in the trust upon the second spouse's death (including all appreciation) to your chosen beneficiaries – such as children, other relatives or even another trust – free of federal estate taxes.

### **Managing the Trust**

When establishing and managing the bypass trust, one important decision is who should serve as the trustee – the entity that will oversee the investment management responsibilities, file tax returns and perform other duties. If the surviving spouse assumes the responsibility, he or she will be limited to taking distributions from the trust for the purpose of health, education, maintenance and support. For that reason, many people choose a close family member, a financial institution or a combination of the two to act as trustee.

### **Management and Distribution Issue**

Consider allocating a significant portion of bypass trust assets to growth-oriented investments such as stocks because any appreciation on the money you place in a bypass trust is sheltered from federal estate taxes. The surviving spouse might also consider spending any money that's outside of the trust first, thereby giving the money in the trust more time to grow. If you leave the assets in the trust until the death of the surviving spouse it leaves a much larger gift to your heirs.

### **Know the Law**

It also pays to keep up with changes in the rules and regulations that affect bypass trusts. Under current law, the \$2 million estate tax exemption for individuals is set to rise to \$2.5 million in 2009. The federal estate tax will disappear altogether in 2010 only to return in 2011 with an exemption of just \$1 million. Furthermore, some states now give trustees more flexibility to change the terms of the trust to meet the fluctuating income needs of a surviving spouse over time. Working with your legal and tax advisors, you can determine if a bypass trust makes sense for you, your spouse and your family.

### **What to Ask Your Attorney and Financial Advisor**

- Every estate is different; ask about how a bypass trust may fit in with your particular situation.
- Ask how changes to the federal estate tax exemption may impact your bypass trust strategy.
- Does each spouse have enough assets properly titled to fund a bypass trust at their death?
- Keep them apprised of any changes in your marital status and beneficiary designations to make sure your estate plan is up to date.