I. INTRODUCTION

In this new era of a significantly increased estate tax exclusion and the option to elect portability, the tax concerns of many married couples have pivoted from estate tax avoidance to income tax avoidance, especially if their assets are valued below the estate tax exemption amount. As such, many clients no longer need complicated and administratively burdensome trust designs. Instead, an estate plan that leaves all assets to a surviving spouse, either outright or in trust, can meet a couple's goals by avoiding estate tax, easing administration, and reducing income tax exposure.

This article provides a brief history of the bypass trust, the advantages and disadvantages of the bypass trust, and methods by which a client may terminate a bypass trust at varying stages of the client’s life. The techniques discussed in this article primarily benefit clients with estates less than that of a single estate tax exclusion ($5.45 million in 2016) or less than the combined exclusion where the surviving spouse elects portability of the deceased spouse’s unused exclusion amount.

II. BACKGROUND OF THE BYPASS

A bypass trust (also referred to as a credit shelter trust or a tax exemption trust) is an estate planning tool commonly used by married couples who create trusts referred to as “AB” trusts or “ABC” trusts. These trusts provide for the creation of subtrusts upon the death of the first spouse to die. In “AB” trust designs, the “B” trust or bypass trust is funded with assets up to an amount equal to the deceased spouse’s unused exclusion amount and is irrevocable. The “A” trust holds the balance of the couple’s assets and remains revocable by the surviving spouse.

Alternatively, in a typical “ABC” trust design, to the extent that the deceased spouse’s assets exceed the deceased spouse’s estate tax exclusion amount, those excess assets are held by the “C” trust (also referred to as a marital trust, qualified terminable interest property (“QTIP”) trust, or marital deduction trust).

Under the above trust designs, at the second death, the assets in the “A” trust and “C” trust are includable in the surviving spouse’s taxable estate. However, the bypass trust receives special treatment and “bypasses” the surviving spouse’s taxable estate, passing to the remainder trust beneficiaries estate-tax free. Between the death of the first spouse and the second spouse, the assets allocated to the bypass trust appreciate free of further estate tax before passing to the remainder trust beneficiaries.

Due to the potentially significant estate tax savings associated with a bypass trust, many existing estate plans include bypass trust provisions.

III. CHANGING OF THE GUARD

Under the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the “2010 Tax Act”), for the calendar years 2010, 2011, and 2012, the estate and gift tax exclusion amount was $5 million, indexed for inflation. In 2012, the indexed amount was $5.12 million. The 2010 Tax Act also permitted “portability” between spouses, which allowed a surviving spouse to use his or her predeceased spouse’s unused estate tax exclusion.

Assets above the exclusion amount were subject to a 35% estate tax rate. However, the exclusion amounts and rates were scheduled to return to the pre-2001 estate tax levels on January 1, 2013, when a $1 million estate tax exclusion and a top marginal 55% estate tax rate were in effect. Additionally, the portability provisions were scheduled to expire.

On January 1, 2013, the U.S. Congress passed the American Taxpayer Relief Act of 2012 (the “2012 Tax Relief Act”). The 2012 Tax Relief Act was signed into law by President Obama on January 2, 2013. The 2012 Tax Relief Act made permanent the changes made by the 2010 Tax Act. It provides for a $5 million estate and gift tax exclusion (including an annual inflation adjustment), a 40% tax rate, and portability of unused exclusion by the surviving spouse. For 2016, the indexed exclusion amount is $5,450,000.

IV. ADVANTAGES AND DISADVANTAGES OF A BYPASS TRUST

A. Advantages

While the increased exclusion amounts and the portability of that exclusion between spouses under the 2010 Tax Act and 2012 Tax Relief Act eliminated the need for bypass trusts in many estate plans, there still remain undeniable benefits to the bypass trust structure.
First, because a bypass trust is irrevocable, it safeguards the testamentary intent of the deceased spouse. This is particularly relevant in a blended family, where each spouse may want to ensure that their share of the estate is “locked in” for their chosen remainder beneficiaries (perhaps children from a prior marriage), and not distributed to the surviving spouse’s beneficiaries, or to the surviving spouse’s new spouse. If the spouses want the survivor between them to retain some flexibility as to whom will receive the trust assets upon the survivor’s death, the bypass trust language can incorporate a limited power of appointment for the surviving spouse. This provision would allow the surviving spouse to appoint the trust assets among a class of beneficiaries (e.g., “the issue of the deceased spouse”). Such flexibility can be important when unanticipated circumstances arise, such as a child needing a special needs trust after the first spouse’s death. If granted a limited power of appointment, the surviving spouse can appoint the bypass trust assets to a new special needs trust to provide for that child, rather than have the bypass trust assets locked into the existing distribution scheme.

Second, because the deceased spouse’s generation-skipping transfer (“GST”) tax exemption is not portable, the bypass trust can provide tax benefits that cannot be obtained otherwise. A bypass trust can maximize use of the deceased spouse’s GST tax exemption by allocating it to a GST tax exempt bypass trust, preserving the GST tax exemption for the remainder trust beneficiaries.

Third, and as discussed above, a bypass trust protects growth on trust assets from further estate tax on the surviving spouse’s death.

Fourth, a bypass trust that includes a spendthrift provision may protect the bypass trust assets from the reach of the surviving spouse’s creditors if those assets are not distributed to the surviving spouse. It also may protect the surviving spouse who remarries and later dissolves that marriage.

Lastly, a bypass trust can provide property tax benefits in California. A distribution to a child from the bypass trust is considered a transfer from the decedent spouse, and not the surviving spouse, thus capturing the decedent spouse’s $1 million parent-child property tax reassessment exclusion that applies to transfers of property other than a residence. An additional $1 million in reassessment exclusion can be very beneficial for spouses who own valuable commercial, rental or vacation properties.

B. Disadvantages

A major disadvantage of a bypass trust relates to income tax. When an individual dies, the income tax basis of the decedent’s assets, with certain exceptions, is adjusted to the fair market value of the assets as of the decedent’s date of death. This is commonly referred to as the assets receiving a “step-up in basis.” Exceptions to this basis adjustment include cash, life insurance, and income with respect to decedent items. The basis adjustment affects any gain or loss on a later sale of the asset. The basis adjustment also resets the depreciation value for depreciable assets, and frequently results in a higher depreciation deduction for the surviving spouse. If an asset is considered community property, 100 percent of the asset receives the step-up in basis upon the decedent spouse’s death.

A decedent’s assets qualify for the step-up in basis only if the assets are includable in the estate of the decedent for estate tax purposes. Where there is a bypass trust in place at the second death, the assets in the bypass trust do not receive the step-up in basis because the assets are not includable in the estate of the surviving spouse. By contrast, assets allocated to a marital trust instead of a bypass trust are includable in the estate of the surviving spouse for estate tax purposes. As a result, those assets will receive a step-up in basis at the death of the second spouse.

Since the assets in the bypass trust receive a step-up in basis only at the first death and not at the second death, any appreciation in the assets after the first death will be subject to capital gains tax when those assets are sold. This may cause a significant income tax liability for the remainder beneficiaries—an income tax liability that could have been avoided if a bypass was not needed to avoid estate tax. If the bypass trust assets must be liquidated upon the second death to facilitate the distribution of those assets, this is a particularly harsh result for those beneficiaries.

As an example, Bill and Betty own real property in California and have an “AB” trust design. Bill died in 2013, at which time Bill and Betty’s combined community property estate was $7 million. The bypass trust was funded with $3.5 million in real property, and the surviving spouse’s trust was funded with $3.5 million in real and personal property. Betty then dies in 2015, at which time the surviving spouse’s trust is valued at $5 million and the real property in the bypass trust has appreciated to $5 million. If the bypass trust beneficiaries choose to then sell the real property, they face income tax on the $1.5 million value increase.

However, if Bill and Betty had amended their trust to a surviving spouse’s trust only, or a surviving spouse’s trust and marital trust design, or if, after Bill’s death, Betty were able to terminate the bypass trust, all of the assets would have
been included in Betty’s taxable estate. As a result, those assets would have received a second step-up in basis. The remainder beneficiaries could then sell the appreciated real property without income tax consequences. In addition, had Betty elected portability after Bill’s death, at her death there would be no estate tax, as Bill and Betty’s combined estate tax exclusions would exceed the $10 million total value of their estate (assuming they made no lifetime gifts to which any of that exemption was applied).

In addition to potential adverse income tax consequences, a client who established a bypass trust must bear the cost of creating, funding, and maintaining that trust. For example, the trustee of the bypass trust must obtain a separate tax identification number for the trust, maintain separate books and records, and prepare and file separate tax returns every year. Additionally, the bypass trust complicates the surviving spouse’s individual income tax returns, which must track any income received by the surviving spouse from the bypass trust.

Further, because the bypass trust is irrevocable, the trustee owes fiduciary duties to the remainder beneficiaries. Such duties include a duty of loyalty, a duty of impartiality between the income and remainder beneficiaries, a duty to keep books and records, and a duty to render an accounting.

Finally, a principal residence held in a bypass trust is not eligible for the exclusion of gain on the sale of a principal residence allowed in Internal Revenue Code, section 121.

V. TECHNIQUES TO BUST THE BYPASS

Once the practitioner and his or her clients have determined that the bypass trust is no longer needed, there are several options, depending on the stage of administration, as to how best to proceed.

A. When Both Spouses Are Alive and Have Capacity

When both spouses are alive and have capacity, eliminating the bypass is as simple as amending and restating their trust to remove or alter the bypass trust provisions.

B. When One Spouse Lacks Capacity

Once one spouse loses capacity, amending estate planning documents is complicated. Because most jointly settled trusts require that both spouses consent to amendments or revocations with regard to their property, amending a trust is not an option when one spouse loses capacity. In this situation, the spouse with capacity can explore the availability of (1) executing an amendment as the attorney-in-fact under a Durable Power of Attorney, (2) petitioning the court under the Probate Code’s substituted judgment statutes, or (3) petitioning the court under Probate Code section 3100.

Under all of these options, the practitioner must consider the remainder beneficiaries. When one spouse is incapacitated, the simplest modification methods (which provide for distribution outright or to a trust that remains revocable after the first spouse’s death) work best when the remainder beneficiaries are the same for the bypass trust and the surviving spouse’s trust and the surviving spouse is unlikely to change the beneficiaries. These methods will be more difficult, if not impossible, to accomplish where the remainder beneficiaries of the bypass trust differ from those of the survivor's trust or where there is animosity between the bypass trust beneficiaries and the surviving spouse.

1. Amendment of Trust Document Using a Durable Power of Attorney

Durable Powers of Attorney (“DPOAs”), as opposed to Nondurable Powers of Attorney, remain in effect even when the principal is incapacitated, and some form of DPOA is a standard part of most clients’ estate plans. The DPOA may be drafted so that the principal grants authority to the attorney-in-fact to act on the principal’s behalf with respect to any lawful subjects, and the acts done by the attorney-in-fact during the period of the principal’s incapacity are as binding as if done when the principal had capacity.

A DPOA's terms may give the attorney-in-fact the power to create, modify, revoke, or terminate a trust, in whole or in part, but such powers can be exercised only if expressly authorized in the DPOA. However, the powers to modify or revoke a trust created by the principal must be echoed in the trust document with language allowing the attorney-in-fact to take such action on behalf of the settlor of the trust. If the trust document provides that amendment powers are personal to the settlor and are not exercisable by an attorney-in-fact under a DPOA, then this method is not an option for amending or revoking the trust.

However, if both the DPOA and the trust give the attorney-in-fact the power to amend or revoke, the incapacitated settlor's attorney-in-fact and the spouse with capacity may execute a trust amendment to remove the bypass trust provisions.

Amendments facilitated by an attorney-in-fact require no public court filing or remainder beneficiary consents. However, practitioners and clients should keep in mind the wisdom that “sunlight is the best disinfectant.” An exercise...

Volume 18, Issue 2 • 2012

CALIFORNIA TRUSTS AND ESTATES QUARTERLY
of power by an attorney-in-fact is made in a fiduciary capacity, and may be subject to future challenge by beneficiaries once it is discovered.31

2. Substituted Judgment Petition

If an incapacitated spouse is conserved, the conservator or other interested party may file a petition for substituted judgment under Probate Code sections 2580 et seq. The petition may request an order of the court authorizing or requiring the conservator to take any action that benefits the conservatee or the estate, or minimizes current or prospective taxes or expenses of administration of the conservatorship estate or of the conservatee’s estate upon death.32

The petition also may request an order of the court allowing a conservator to make gifts on behalf of the conservatee and to revoke or modify a revocable trust. However, a conservator may not revoke or modify a trust if the trust instrument evidences an intent to reserve the right of revocation or modification exclusively to the conservatee, provides expressly that a conservator may not revoke or modify the trust, or otherwise evidences an intent that would be inconsistent with authorizing or requiring the conservator to exercise the right to revoke or modify the trust.33

Before pursuing a petition for substituted judgment, practitioners should carefully read the existing trust instrument to determine whether the trust language reserves the powers of amendment and revocation solely to the settlors. If such a restriction exists, this method is not an option for removing the bypass trust provisions.

If the trust instrument is silent or otherwise affirmatively allows a conservator to modify or revoke the trust instrument, a conservator can amend a bypass trust through a petition for substituted judgment. Notice of the petition must be given for the period and in the manner provided in Probate Code section 1460 et seq. to the following persons:

a. The persons required to be given notice under Chapter 3 (commencing with section 1460 of Part 1).

b. The persons required to be named in a petition for the appointment of a conservator.

c. So far as is known to the petitioner, beneficiaries under any document executed by the conservatee which may have testamentary effect unless the court for good cause dispenses with such notice.

d. So far as is known to the petitioner, the persons who, if the conservatee were to die immediately, would be the conservatee’s heirs under the laws of intestate succession unless the court for good cause dispenses with such notice.

e. Such other persons as the court may order.34

The court may order the requested modification if (1) the conservatee is either not opposed to the petition or, if opposed to the petition, the conservatee lacks legal capacity, and (2) either the requested action will have no adverse effect on the estate, or the remaining estate will be adequate to provide for the conservatee.35

Further, the court must take into consideration all relevant circumstances, including, but not limited to the thirteen enumerated factors in the Probate Code that range from the wishes of the conservatee to the tax implications of the actions.36 In drafting the petition, practitioners may want to consider emphasizing that complicated estate tax planning is unnecessary given the size of the conservatee’s estate. The petition should argue that it would be unduly burdensome and costly to administer a separate irrevocable bypass trust, and the court should terminate the bypass trust and provide for all assets to be distributed to the surviving spouse (or for such assets to remain in a revocable trust for the benefit of the surviving spouse). Such a petition should also emphasize the potential income tax liability if the bypass trust were not amended and the assets in that trust were to fail to receive an additional step-up in basis when the second spouse died. Practitioners should keep in mind that this technique may cause the trust to become a court supervised trust.

3. Probate Code Section 3100 Petition

If a spouse is incapacitated but not conserved, a petition under Probate Code section 3100 will accomplish the same goals as a substituted judgment petition. Probate Code section 3101, subdivision (k), provides that a “proceeding may be brought under this chapter for a court order authorizing a proposed transaction, whether or not the proposed transaction is one that otherwise would require the joinder or consent of both spouses” if certain conditions are met.

A petition under Probate Code section 3100 et seq. may be brought as long as one spouse lacks legal capacity, and the other spouse either has legal capacity or has a conservator.37 It also may be brought for a court order determining that a spouse has legal capacity to enter into a transaction.38 This would be particularly useful where it is unclear whether one or both spouses have the capacity to modify or amend the trust,
and a determination needs to be made before other steps are taken.

As with the substituted judgment petitions discussed above, practitioners must review the trust instrument to determine whether the powers for amendment and revocation are personal to the settlor or able to be exercised by any third party.

Probate Code section 3100 et seq. is particularly helpful when one spouse is unable to make competent decisions regarding his or her financial affairs, but a conservatorship is not otherwise necessary. Lacking capacity, that spouse would be unable to execute a trust amendment to change the terms of a bypass trust. Although Probate Code section 3100 et seq. does not specifically address the modification or termination of a trust, a court may rely on Probate Code section 3102, which provides for transactions involving “conveyance or transfer without consideration, to provide gifts for such purpose, and to such charities, relatives, friends, or other objects of bounty as would likely be beneficiaries of gifts from spouses.” The modification of a trust instrument that involves dispositions to a spouse and children is within the scope of Probate Code section 3100.

C. After the Death of Deceased Spouse

After the first spouse dies and the bypass trust becomes irrevocable, the options to “bust” the bypass trust become more limited and burdensome.

1. Note for Assets Allocated to the Bypass Trust

One option to address an unwanted bypass trust is to fund it with an unsecured demand promissory note from the surviving spouse’s trust which does not become due and payable until the surviving spouse’s death. Use of the note will leave all other assets under the surviving spouse’s control in the surviving spouse’s trust.

This technique, however, has its risks. A bypass trust remainder beneficiary who is cooperative and agreeable with the surviving spouse at the time of initial administration may not always be so. To fund the bypass trust with a note is risking a future complaint for breach of fiduciary duty for failing to appropriately invest the bypass trust assets under the Uniform Prudent Investor Act and maximize appreciation for the bypass trust remainder beneficiaries. The remainder beneficiaries would have an additional complaint if the surviving spouse’s trust were depleted by the time of the surviving spouse’s death and unable to repay the note to the bypass trust. Further, income tax issues must be considered as the IRS could easily argue that the note is a purchase by the surviving spouse’s trust of the bypass trust assets. If the IRS were to reclassify this transaction as a deemed sale, the bypass trust would recognize gain to the extent that values increased from the date of death to the date of funding.

2. Disclaimer of Bypass Trust Assets

A surviving spouse always has the option to disclaim his or her interest in the bypass trust, thereby immediately transferring the assets from the bypass trust to its remainder beneficiaries. This has the benefit of reducing the administrative burden on the surviving spouse by immediately terminating the bypass trust.

However, because this method immediately transfers the assets to the bypass trust remainder beneficiaries, this technique is only recommended where the surviving spouse has sufficient assets outside of the bypass trust to meet the needs of the surviving spouse. Additionally, the surviving spouse must disclaim the bypass trust assets within nine months of the deceased spouse’s date of death and adhere to the other requirements of a valid disclaimer.39

If the surviving spouse neglects to disclaim the bypass trust within nine months of the deceased spouse’s date of death, the surviving spouse could still disclaim the bypass trust and subject the transfer to gift tax. This result might not be of consequence if the value of the assets includable in the survivor’s estate is far below the survivor’s available gift/estate tax exemption and those assets likely will not appreciate in value during the survivor’s remaining lifetime.

3. QTIP-ing A Bypass Trust

If a QTIP election is made for the bypass trust, those assets will be included in the surviving spouse’s estate for estate tax purposes and will qualify for a second basis step-up. However, to make such an election, the bypass trust must meet the requirements for a QTIP trust. These requirements include (1) the income of the trust may only be paid to the surviving spouse, (2) trust principal may only be invaded for the benefit of the surviving spouse, and (3) an election must be made on a timely-filed estate tax return (Form 706).40

Even if the bypass trust provides for all the income to be distributed to the surviving spouse and permits principal invasion only for the benefit of the surviving spouse, some bypass trusts restrict the trustee from making the QTIP election. In this case, QTIP-ing the bypass would not be possible. In addition, before moving forward with QTIP-ing a bypass trust, a practitioner must undertake a detailed review
of the federal requirements of a QTIP trust to ensure the ability to comply strictly with those requirements. For example, the rules require that a surviving spouse be able to make the assets productive. Finally, some practitioners are concerned that Rev. Proc. 2001-38 may be used by the IRS to void a QTIP election for basis purposes under these circumstances, because the QTIP election is not necessary to eliminate estate tax.\textsuperscript{41}

4. Terminations, Modifications, and Reformations of Bypass Trusts

While the option may exist under the Probate Code to terminate or modify a bypass trust, or under common law to reform a bypass trust, practitioners must proceed with great caution.\textsuperscript{42} Before taking any of these actions, practitioners must consider whether the action will trigger a no-contest clause in the trust.\textsuperscript{43} There can also be significant income tax consequences to a termination, modification, or reformation of a trust in which a sale is deemed to have occurred between the holders of the life estate and the remainder interest, resulting in capital gains (with recognition of gain on the income interest computed with a zero basis).\textsuperscript{44} In addition, it should be noted that under Commissioner v. Estate of Bosch, the Supreme Court held that the IRS is not bound by a state court determination and the IRS might deny a step-up in basis if it determines that the facts do not support the court’s action.\textsuperscript{45} Accordingly, practitioners must be circumspect when engaging in these state law tactics as there is no federal tax certainty. Lacking that certainty, taxpayers should request a private letter ruling to know the federal tax consequences of such actions.

VI. CONCLUSION

The reports of the death of the bypass trust have been greatly exaggerated—it remains a relevant estate planning tool for larger estates, for clients who wish to ensure that their testamentary wishes are not ignored (particularly those with blended families), or for surviving spouses who need the creditor protection of an irrevocable trust. However, busting a bypass trust is a great option for those clients who grudgingly agreed to a more complicated plan only for the estate tax savings, and who would both prefer to avoid the administrative burden of an irrevocable trust during the surviving spouse’s lifetime and allow their remainder beneficiaries to potentially benefit from a second basis adjustment at the surviving spouse’s death.

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2 IRC, sections 2010(c)(4) and (5).
3 The first spouse to die is hereinafter referred to as the “decedent spouse.”
4 The “A” trust is always included in the surviving spouse’s estate, as the “A” trust assets are owned entirely by the surviving spouse under IRC, section 2031. The “C” trust takes advantage of the marital deduction under IRC, section 2056(b)(7) and, as a result, its assets are included in the surviving spouse’s estate, under IRC, section 2044.
5 IRC, section 2031.
11 Ibid.
13 Ibid.
15 The background of the inability to port a decedent’s unused GST tax exemption and solutions for capturing unused GST tax exemption are beyond the scope of this article.
16 This also applies to Qualified Terminable Interest Property (or, QTIP) trusts.
18 IRC, section 1014(a)(1). If alternate valuation is available and elected on a timely filed estate tax return, the basis adjustment is the alternate value. IRC, section 1014(a)(2).
19 IRC, section 1014(c).
20 IRC, section 1014.
21 IRC, section 1014(b)(6).
22 IRC, section 1014(b)(1). Generally, all community property and the deceased spouse’s separate property.
23 Prob. Code, section 16000 et seq.
24 Frequently, the trustee of the bypass trust is the surviving spouse. In addition, the surviving spouse is generally the current income beneficiary of the trust. If the surviving spouse is the trustee and the current income beneficiary of the trust, the trustee does not have a duty to render annual accountings unless the trust document states otherwise. However, it is common practice to include the trustors’
children or more remote descendants as permissible principal beneficiaries of a bypass trust. In such case, there is a duty to render annual accountings.

26 Prob. Code, section 4123.
27 Prob. Code, section 4125.
28 Prob. Code, section 4264.
29 Ibid.
30 Brandeis, Other People’s Money: and How the Bankers Use It (1914) p. 92.
32 Prob. Code, section 2580, subd. (a).
33 Prob. Code, section 2580, subd. (b)(11).
34 Prob. Code, section 2581.
36 Prob. Code, section 2583.
37 Prob. Code, section 3101.

38 Ibid.
39 IRC, section 2518(b).
40 IRC, section 2056(b)(7).
41 The application of Rev. Proc. 2001-38 to a trust that is not taxable for estate tax purposes is the subject of a pending Treasury-IRS guidance project to produce a clarifying revenue procedure (Item 4 of the 2015-2016 Priority Guidance Plan). Many practitioners believe that the guidance will be favorable.
44 Treas. Reg. section 1.1001-1(a); PLR 200231011 (Aug. 2, 2002).