New law raises the estate tax exemption to $5,250,000 per person

BY GENE L. OSOFSKY, ESQ.

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Q: My wife and I had our Living Trust prepared about eight years ago. I hear there's a new tax law which just went into effect. Is it time to have our trust reviewed?

A: You refer to the recently enacted “American Taxpayer Relief Act,” which has permanently enlarged the estate tax exemption to $5,250,000 per person (for 2013). It also permits a married couple to effectively double their exemption even without special estate tax planning.

By comparison, when you created your trust the estate tax exemption was much smaller, and special tax planning was required to minimize estate taxes.

At that time, your attorney probably recommended a form of trust which was tailored to the lower estate tax exemption, namely a Living Trust with a Bypass Sub-Trust built into it. This Bypass Sub-Trust is also known as a “B Trust,” an Exemption Trust, a Family Trust or a Credit-Shelter Trust.

Bypass Trusts typically require that, on the death of the first spouse, a share of the couple’s assets be transferred into an irrevocable sub-trust called the “Bypass Trust” rather than to the survivor directly. This is to preserve the first spouse’s estate tax exemption for later use at the survivor’s death.

Without the Bypass, the first spouse's exemption would be lost and all trust assets at the survivor's death would be sheltered by only the survivor's one exemption, and the excess (if any) was exposed to an estate tax at a rate as high as 55 percent. Understandably, couples went to great lengths to avoid that tax.

The typical Bypass Trust was not, however, without its problems:

(1) The survivor lost the right to make any changes in the Bypass portion even if family circumstances changed;

(2) The survivor's access to principal in that portion was typically restricted;

(3) The Bypass interfered with applying for a Medi-Cal long-term-care subsidy; and…

(4) The assets in the Bypass Trust usually required separate accounting and income tax returns during the lifetime of the survivor. Surviving spouses usually found the restrictions burdensome.

There are two important new developments which arrived with the new law: (a) As of 2013, the amount of the estate tax exemption has now permanently increased to $5,250,000 per person, to be annually adjusted for inflation; and (b) the unused portion of the first spouse's full exemption is now preserved for use by the second spouse even without the use of the restrictive Bypass Trust, effectively doubling the exemption for most couples.

In view of these new developments, couples with Bypass Trusts created for estate tax purposes under the old law should have their trusts reviewed and, where appropriate, consider eliminating the mandatory funding feature at the first spouse's death.

Instead, they might now consider plans which give the survivor the option of doing postmortem planning after the first death, e.g. by funding a portion of trust assets into an optional Disclaimer Trust. The Disclaimer Trust would then operate as a tax-saving Bypass Trust if that later appeared necessary due to the increase in value of the couple's estate.

An exception to the above recommendation is the use of the mandatory Bypass Trust is still useful for non-tax purposes, e.g. in situations involving second marriages. Here, each spouse usually wishes to provide financial security for the survivor, but also wishes to preserve a portion of assets for his or her own children. Under these circumstances, a Bypass Trust can still help these couples achieve their estate-planning goals.

Gene L. Osofsky is an elder law and estate planning attorney in Hayward. Visit his website at www.LawyerForSeniors.com.