

**Estate Planning for Spouses with Marital Deduction / Bypass Trusts
After the Tax Cuts and Jobs Act**

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The Tax Cuts and Jobs Act ("Act") which became law in December 2017, once again changed the landscape of estate planning, at least for a limited time. The estate, gift and generation skipping transfer tax exemptions each increased to \$10,000,000, indexed for inflation, for each individual.¹ However, those changes will sunset on December 31, 2025, and the law will return to the 2017 levels, unless the Congress does something to change the sunset provision. The following table describes the applicable periods, exemption amounts and rates.

Effective for Taxable Years	Estate Tax Exemption / Rate	Gift Tax Exemption / Rate	Generation Skipping Transfer Tax Exemption / Rate
2012 through Dec. 31, 2017	\$5,000,000, indexed for inflation / 40% top rate	\$5,000,000, indexed for inflation / 40% top rate	\$5,000,000, indexed for inflation / 40% top rate
after Dec. 31, 2017 and before Jan. 1, 2026	\$10,000,000, indexed for inflation ² / 40% top rate	\$10,000,000, indexed for inflation / 40% top rate	\$10,000,000, indexed for inflation / 40% top rate
January 1, 2026	?	?	?

If you and your spouse currently have an estate plan which includes a revocable marital deduction / bypass trust plan, there are certain things you may wish to consider as a result of the Act.

I. Design of the marital deduction / bypass trust.

For a married couple, the marital deduction / bypass trust, sometimes referred to as an AB trust, can take the form of a revocable living trust created by each spouse as grantor, or as is more typical, a joint revocable trust created by both spouses as grantors. On the death of the first spouse the trust usually provides it be divided into two trusts, one identified as a "bypass trust" or "Trust B," and the other identified as a "marital deduction trust" or "Trust A." The purpose of the division is to preserve the federal estate tax exemption of the first spouse to pass away, *i.e.* the federal estate tax exemption amount of the first spouse is utilized to fund the bypass trust, and thus federal estate tax on those assets is avoided. The balance of the assets also avoids federal estate

¹This article only addresses individuals who are U.S. citizens.

²The Act changed how the inflation adjustment is calculated. Under the Act the inflation adjustment is now based on the chained Consumer Price Index, rather than the prior traditional Consumer Price Index. The change should result in smaller annual increases in exemption amounts.

tax because the unlimited federal marital deduction allows those assets to pass to the marital deduction trust, estate tax free.

Usually the primary beneficiary of the bypass trust is the surviving spouse, with all of the income generated by the assets in the bypass trust paid to the surviving spouse, and the principal in the bypass trust used for certain expenses of the surviving spouse, such as health and support, but not generally accessible to the surviving spouse. In return for the limits placed on what the principal in the bypass trust may be used for, those assets will not be included in the surviving spouse's estate for federal estate tax purposes at his or her death, and thus pass to the contingent beneficiaries of the bypass trust free of federal estate tax.

The surviving spouse is the beneficiary of the marital deduction trust, and the assets which fund the marital deduction trust may be used by the surviving spouse for any purpose. On the death of the surviving spouse, the assets typically pass to the bypass trust and then to the beneficiaries of the bypass trust federal estate tax free, by utilizing the federal estate tax exemption of the surviving spouse.

II. Downside of the marital deduction / bypass trust structure.

The following are a few of the potential issues using the marital deduction / bypass trust structure in today's environment.

1. Increases in the federal exemption amounts under the Act.

Generally a formula is used to determine the amount which funds the bypass trust, the calculation beginning with the deceased spouse's federal estate tax exemption amount. In the late 1990's, the federal estate tax exemption amount for an individual was \$600,000. If a married couple's assets held by their marital deduction / bypass trust exceeded that amount, the marital deduction / bypass trust estate plan structure made sense. For example, if the assets owned by the trust were valued at \$1,000,000 on the death of the first spouse, the bypass trust could possibly be funded up to the \$600,000 amount, and the balance, \$400,000, funding the marital deduction trust.

The *Economic Growth and Tax Relief Reconciliation Act of 2001* began a gradual increase in the individual federal estate tax exemption amount. The Act has added fuel to the fire. In its simplest terms, under the formula the higher the individual federal estate tax exemption amount, the less likely there will be funding of the marital deduction trust, or possibly no funding of that trust.

For example, if a marital deduction / bypass trust includes the above formula, and in 2018 the trust owned assets valued at \$5,000,000 and the first spouse passed away in 2018, the formula would direct the entire \$5,000,000 be used to fund the bypass trust, and no assets would be left to fund the marital deduction trust. That is because each individual's federal estate tax exemption amount in 2018 was \$11.18 million. If it is important that the surviving spouse have unrestricted access to assets, then the marital deduction / bypass trust structure may not be appropriate now.

2. Use of the income tax basis of assets.

Currently, the income tax basis of an asset held by an individual will be "stepped up" to the fair market value of that asset on the individual's death, and received by the beneficiary or heir at that fair market value. For example, if an individual bought a house in 1980 for \$50,000 and passed away in 2018, with the house then appraised at \$150,000, the beneficiary or heir would receive the house at its then fair market value, \$150,000, *i.e.* receive a "stepped up" income tax basis in the house at that amount. If the beneficiary or heir sold the house in 2019 for \$160,000, the beneficiary or heir would only pay income tax on the \$10,000 difference between the sales price and the fair market value of the house.

In the context of the marital deduction / bypass trust, on the death of the second spouse, the assets in the bypass trust do not receive a "stepped up" income tax basis to their then current fair market value, but pass to the contingent beneficiaries of the bypass trust without the "stepped up" income tax basis. The assets in the marital deduction trust do receive a "stepped up" income tax basis.

If the married couple has contributed assets to the trust which have substantially increased in value over the years, and use of the individual federal estate tax exemption amount to avoid federal estate tax is not an issue, then the couple may wish to consider amending the trust. The amendment could eliminate the marital deduction / bypass trust structure. That would allow the "stepped up" income tax basis to be applied on the death of the first spouse, and on the death of the surviving spouse.

Conclusion.

Amending a marital deduction / bypass trust is one method of addressing some of the issues described above. There are a number of other possible recommendations, which the client may wish to discuss with his or her estate planning attorney.