Bypass and QTIP Trusts

Under federal law, each individual has an "applicable exclusion amount," a specified dollar amount of asset protected from federal estate tax. Between spouses, however, a person can pass any size estate to his or her U.S. citizen spouse without concern for a federal estate tax because of the "unlimited marital deduction." For many married couples, an "I love you" will simply leaves everything to the surviving spouse.

Before 2011, however, when the surviving spouse later died, and the combined estate passed to the ultimate heirs, there was only the survivor's single applicable exclusion amount to shield the estate from federal estate tax. Using the unlimited marital deduction at the first death, in effect, wasted the applicable exclusion amount of the first-to-die.

To preserve the applicable exclusion amount of the first-to-die, many married couples used a "bypass" trust (also called an exemption or credit shelter trust). At the first death, the bypass trust would be funded with assets up to the applicable exclusion amount in effect for that year. A bypass trust is not subject to federal estate tax at either the first or second death, even though the assets in the trust may appreciate greatly in value.

A bypass trust is also useful in that it can be written to give the surviving spouse access to the income from the trust for life, as well as access to the trust principal, in extreme situations, for his or her health, education, support, and maintenance.

Additional Planning

Sometimes a third trust, called a "QTIP" trust, is added to the bypass trust. QTIP is an acronym for "qualified terminable interest property" trust. The QTIP allows the first spouse to die to give lifetime benefits (such as income earned on trust assets) to his or her spouse, while still retaining the right to name the persons who will ultimately receive the trust assets. Use of a QTIP recognizes that human nature is less than perfect:

> **Children of a prior marriage:** In an age when divorce is common, a QTIP trust is particularly useful in protecting children of a prior marriage from being cut off by a surviving step-parent spouse.
>
> **Close friends:** A QTIP also reduces the possibility of the estate passing to a subsequent marriage partner or "close friend" of the surviving spouse.

Careful drafting is required to make certain the QTIP trust qualifies for the unlimited marital deduction. Special language is required if the QTIP is the beneficiary of an IRA. See Rev. Rul. 89-99, 1989-2CB 231.

Bypass and QTIP Trusts

2010 Tax Relief Act

The 2010 Tax Relief Act brought a number of significant changes to federal estate tax law. One provision of this act increased the applicable exclusion amount for 2011 to $5,000,000 and to $5,120,000 in 2012. Another part provides, for deaths occurring in 2011 and 2012, that any applicable exclusion amount that remains unused at the death of the first spouse to die is generally available for use by the surviving spouse, as an addition to his or her own applicable exclusion amount.[1] For 2011 and 2012, the combined effect of these two legislative changes protects up to $10,240,000 in assets from federal estate tax for a married couple, with or without a bypass trust or a QTIP trust.

2013: The World Changes - Again

Most of the provisions of the 2010 Tax Relief Act are scheduled to "sunset" at the end of 2012. Unless changed by Congress, in 2013 federal estate tax law will revert to that in effect under earlier legislation, with a relatively low applicable exclusion amount of $1,000,000. In such a planning environment, a bypass trust will once again become a key component of many estate plans. For reasons mentioned earlier, a QTIP trust may be advisable, regardless of the value of the applicable exclusion amount. Individuals with estates (including retirement plans and life insurance) large enough to be subject to the federal estate tax are strongly advised to consult frequently with their financial and legal advisors.

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[1] Although not spelled out in the law, it appears that both spouses would have to die in 2011 and/or 2012 in order for this "carry over" to apply.