

Trusts May Ease Estate Tax Bill

by Kenneth Bloom, Esq.

The estate-tax law, passed by Congress in 2001 and in effect until 2011, offers annual, increasing estate-tax exemptions, descending estate tax rates – and pitfalls for taxpayers who fail to set up properly structured “bypass” trust.

So says Kenneth Bloom, a partner in Peck, Bloom, Austriaco & Mitchell, a Chicago law firm that specializes in law for older Americans.

Bypass trusts are often used in the estate planning to decrease high taxes faced by non-spousal heirs.

This special trust is created to make the increasing estate tax exemption work to the heirs’ advantage on a year-by-year basis. (Surviving spouses generally do not pay estate or gift taxes on money or property inherited. But a 49-percent tax rate is faced by non-spousal heirs.)

For example, says Mr. Bloom, a bypass trust may be created to stipulate that the maximum exemption in the year of the taxpayer’s death be left in a bypass trust for spousal and non-spousal relatives with the rest of the estate being left in a marital trust for the living spouse.

Since \$1 million was the exemption amount for taxes paid in 2002 and 2003, no estate taxes would be paid on this amount, and it would be kept in the bypass trust until the other spouse dies.

The amount that can be left in the bypass trust would increase according to the estate tax law, he says. In 2003, as in 2002, the tax exemption is \$1 million. This figure climbs to \$1.5 million in 2004 and on up to \$3.5 million in 2009. In 2011 the exemption returns to the 2001 tax rate of 55- percent with a \$1 million exemption.

Here is a scenario used by Mr. Bloom to show what would happen without a bypass trust.

Bob and his wife Wanda together had \$4 million in money and property. Bob died in 2002, leaving his wife his entire estate. Wanda dies in 2007 with wealth that has doubled to \$8 million. All her assets go to the children.

After paying an estate tax of \$2.7 million, the children are left with \$5.3 million.

Now, here is Mr. Bloom’s version of what would happen if Bob and Wanda had placed \$1 million in a bypass estate trust in 2002.

Bob died in 2002 and left \$1 million in the bypass trust. The balance of the couple’s assets, \$3 million, went to Wanda in a marital trust.

In this version, no estate tax was due in 2002, since the amount going to the bypass trust matched the estate tax exemption for 2002.

Wanda's assets of \$3 million doubled by the time of her death in 2007.

After payment of \$1.8 million in estate taxes, the children receive \$4.2 million from their mother's estate and \$2 million from the bypass trust (the money put in the trust doubled) for a total of \$6.2 million, says Mr. Bloom.

Since the children do not have to pay taxes on the money from the bypass trust, they save \$900,000 that they would have paid in taxes had their parents not established a bypass trust.

Note, says Mr. Bloom, that the children would have to pay capital gains taxes on the appreciation of the assets sold from the bypass trust based on the value of those assets at the time the first spouse died.

But what would happen if Bob dies in 2010, when the estate tax is not in effect, and what if Wanda lives another five years?

If the trust formula dictated that all of Bob's assets could go in the bypass trust because there is no estate tax, would all of Bob's property and money go to the couple's children, leaving Wanda broke?

Mr. Bloom says probably not -- many bypass trusts allow spouses to use money from the principal in the bypass trust, so Wanda would probably not be left penniless.

"But depending on the type of funding formula in the trust, the bypass trust or the marital trust could end up with all the assets," says Mr. Bloom.

"Thus it is critical that existing estate plans be reviewed by a competent estate-planning attorney and that new plans be prepared with great care," he says.

It is possible, Mr. Bloom says, that capital gains taxes would have to be paid by the heirs in 2010 on assets sold. The estate tax rate in 2010, at its highest, is 20 percent -- the current estate tax rate is 49 percent.

A gift tax would also apply. Separate from the estate tax, the gift tax exempts of gifts of \$11,000 or less to any number of sources. Unlike the estate tax, the gift tax is not mandated to expire in 2010.