Bypass Trust Basics

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In this paper I am going to discuss the basics of using a bypass trust to save estate taxes. This paper is intended for (a) attorneys who are just getting started in an estate planning and probate practice, (b) attorneys who dabble in estate planning and (c) legal assistants wanting a basic understanding of how bypass trust planning works. It may benefit more experienced practitioners, but only as a refresher.

I am approaching this subject as if the federal estate and gift tax laws in effect on December 31, 2009, apply, so (unless otherwise indicated) this paper assumes that there *is* an estate tax and that the applicable exclusion amount (which I call the "tax-free amount") is $3.5 million. In appropriate sections I will discuss the effect of the 2010 – 2011 estate tax chaos on bypass trust planning and administration.

1. The basic basics.

Readers who know little or nothing about trusts and the estate tax should read this section. More knowledgeable readers probably should skip it.

a. ***A rose by any other name…*** A bypass trust is used by married persons to shelter a portion of their marital wealth from estate taxation. It goes by different names. This causes confusion in the public and among attorneys who are not estate planning specialists. In general, the following are synonymous:

- Bypass trust
- Credit shelter trust
- Exemption equivalent trust
- The "B" trust when an "A-B" trust or "A-B-C" trust is used
- The "family" trust, as compared to the "marital" trust (although some revocable inter vivos trusts are called "family trusts" which may or may not provide for the creation of a bypass trust)

I refer to all of these as "bypass trusts."

b. ***What is a trust?*** A bypass trust is a type of trust. A trust is a relationship (not an entity) created when one person is given legal title to property to be held and used for the benefit of one or more persons. The person who creates the trust is called the "settlor" (although some documents call them the "trustor" or "trustmaker"). The person receiving legal title is called the "trustee." A person benefiting from the trust is called the "beneficiary."

Usually the settlor creates a trust by signing a written document. This document may be a will, in which case the trust is known as a "testamentary trust" and the settlor is also called the "testator." This document may also be a trust agreement or declaration of trust that takes effect while the settlor is living, in which case the trust is known as an "inter vivos trust" or "living trust." A trust may be "revocable," meaning the settlor can undo or change the trust, or "irrevocable," meaning that the settlor cannot undo the trust and in most cases cannot change the trust. All testamentary trusts are irrevocable since testator is dead.

The written document creating the trust (which I'll call the "trust instrument") often creates several different trusts. For example, the trust instrument may create a trust to benefit the settlor's spouse while living and then create a trust for each of the settlor's children after the death of the settlor's spouse. This can cause confusion, since an inter vivos trust instrument often is named "The Joe and Sally Jones Family Trust" but provides for the creation of multiple trusts. Some trust instruments refer to these as "subtrusts."

c. ***Estate and gift taxes.*** Federal statutes impose a tax on the estates of persons whose property exceeds a certain amount. This amount is known as the "applicable exclusion amount," the "exemption equivalent amount" or the "tax-free amount." It has increased over the years. In 2001, Congress passed the Economic Growth and Tax Relief Reconciliation Act, which increased the tax-free amount from $1 million for persons dying in 2001 to $3.5 million for persons dying in 2009. The 2001 Act eliminated the estate tax for persons dying in 2010. The 2001 Act expires on December 31, 2010, causing the tax-free amount to drop to $1 million for persons dying in 2011 and later. Most estate planners expected Congress to extend the estate tax prior to 2010. Congress did not. Most estate planners now expect Congress to raise the tax-free amount for persons dying in 2011 or later, but time is running out. This period of uncertainty has caused many problems, and some of these problems impact bypass trusts. Except as noted, the rest of this paper assumes that the law in effect on December 31, 2009, applies, so it uses $3.5 million as the tax-free amount.

The estate tax is imposed on most of the property owned or controlled by the decedent, including retirement plan assets and the proceeds of life insurance policies paid at the decedent's death. Estate planners use strategies to avoid taxation on some property, including bypass trust planning.

The estate tax is imposed on the estates of persons who die. To keep people from avoiding the estate tax by giving away their property before death, federal law also imposes a gift tax. In general, the gift tax laws match up with the estate tax laws to eliminate the incentive to give property away during lifetime. Still, often it is advantageous for a person to make gifts rather than holding property until death. For example, a gift may keep the appreciation in value of the property between the date of gift and date of death from being taxed. Under the 2001 Act, the tax-free amount for gift tax purposes is $1 million, *adjusted for inflation.* The tax-free amount for estate tax purposes is reduced by that portion of the tax-free amount for gift tax purposes used during life.

Example 1. Donor gives $1 million of property to his children during life (in gifts that are not otherwise excluded from tax). At death, Donor's tax-free amount for estate tax purposes is $2.5 million ($3.5 million minus the $1 million used to make gifts).

The estate and gift tax rates are vary based on the size of the estate. However, under the 2001 Act, as a practical matter all taxable estates are subject to a 45% rate. (The 2011 Problem, discussed below, may result in some property being taxed at a 55% rate.)

d. ***The marital deduction.*** **Some property that otherwise would be included in a decedent's** estate may be excluded from his or her estate because of deductions permitted by federal law. For example, federal law permits the estate to deduct the value of property given to charity. One of the key deductions – and the one that makes bypass trust planning work – is the marital deduction. The estate may deduct the value of property the decedent gives to his or her spouse, so long as the gift is outright and free of trust or in a qualifying trust. (To qualify, the trust must meet the requirements of "qualified terminable interest property." This type of trust is known as a "QTIP trust" or "marital trust."

e. ***It's a tax on the kids, not the surviving spouse.*** Because of the marital deduction, there will be no estate tax if a married person leaves all of the property to the surviving spouse in a qualifying manner. This is true no matter the size of the estate.

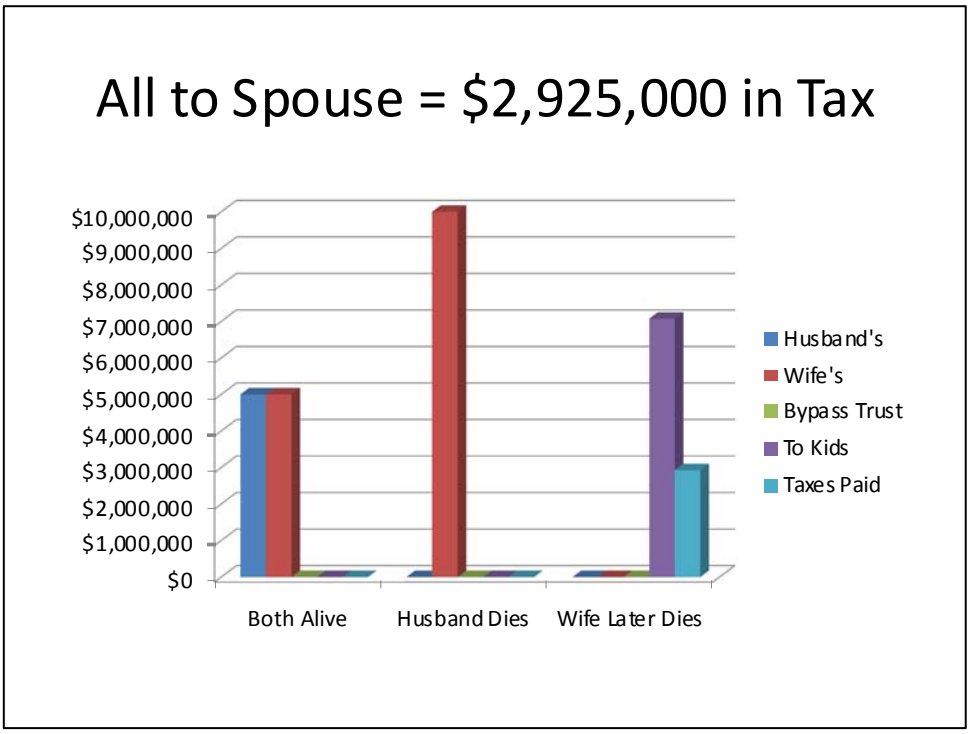
In practice, the marital deduction postpones rather than avoids the payment of estate taxes. The property given to the surviving spouse probably will be in the estate of the surviving spouse – subject to estate taxation – when he or she dies. The tax comes at the death of the second spouse, not at the death of the first.

So, as a practical matter, it usually is the children of the married couple and not the surviving spouse who are faced with paying the estate tax. This affects the willingness of a married couple to use strategies to save estate taxes – especially a married couple with no children. Why should they inconvenience themselves with estate tax planning when the benefit comes only after both are dead?

f. ***Wasting the tax-free amount.*** If the first spouse to die leaves all of his or her property to the surviving spouse, he or she wastes the tax-free amount available to his or her estate. This is because the first $3.5 million given to the surviving spouse is doubly excluded from the estate tax: (1) it is excluded because it falls below the tax-free amount and (2) it is excluded because of the marital deduction.

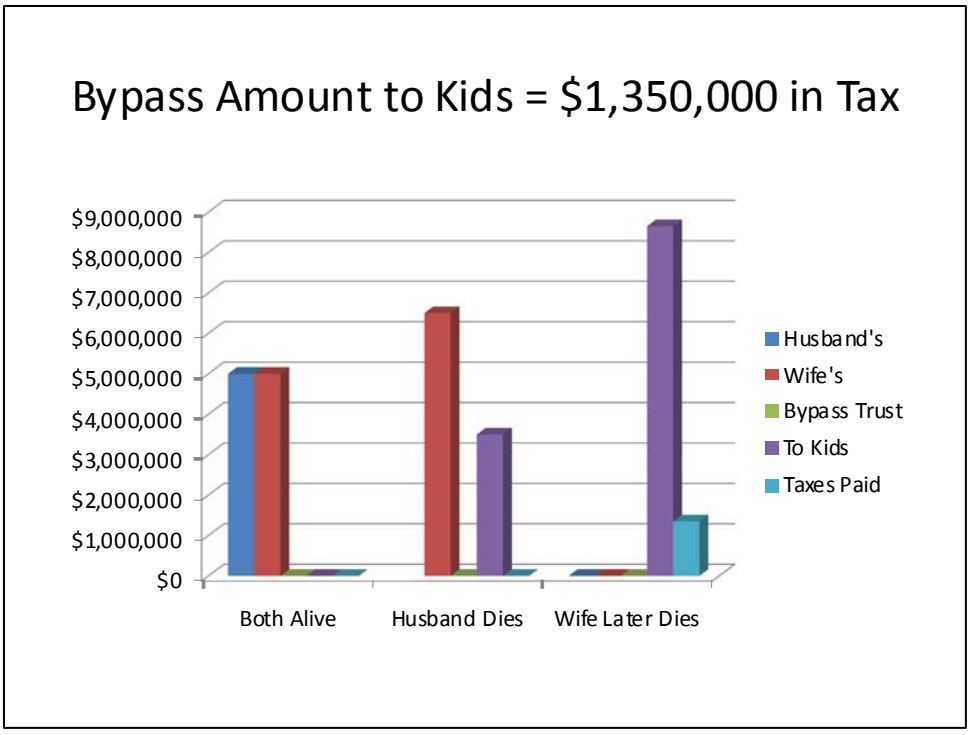
Worse, depending on the size of the estate and the tax-free amount at the time of death, leaving all of the property to the surviving spouse results in "estate stacking." Instead of having two smaller estates subject to taxation (possibly benefiting from lower tax rates which may apply to smaller estates), one large estate – the surviving spouse's – is taxed.

Example 2: *Husband and Wife own property worth $10 million, all of which is community property. Husband dies with a will leaving all of his property to Wife. Husband's $5 million estate is added to Wife's $5 million. Assuming no inflation, Wife's estate will be $10 million at her death. After excluding the $3.5 million tax-free amount, Wife's estate will owe approximately $2.9 million in tax.*



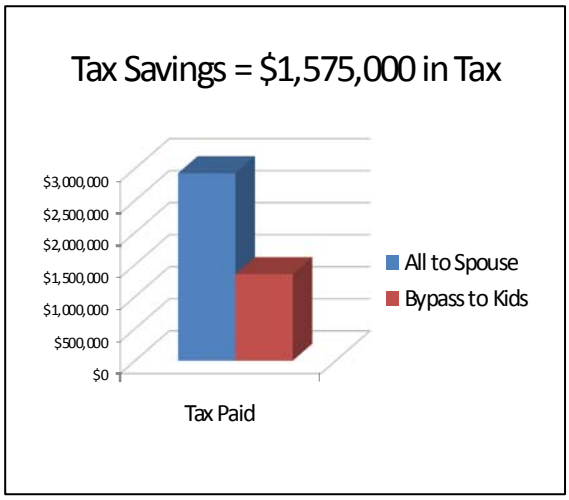
g. ***Leaving property worth the tax-free amount to someone other than the surviving spouse avoids wasting the tax-free amount.*** A married person can avoid wasting his or her tax-free amount by leaving property worth the tax-free amount to someone other than his or her spouse. Giving $3.5 million to the children and the rest to the surviving spouse means that both spouses will utilize the full $3.5 million tax-free amount available to them.

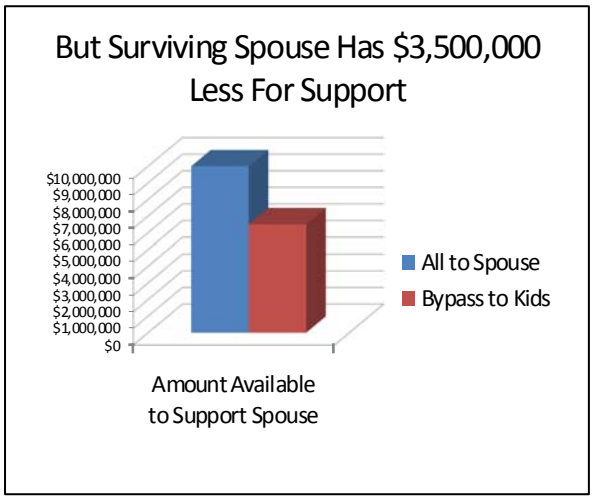
Example 3: *Husband and Wife own property worth $10 million, all of which is community property. Husband dies with a will leaving property worth $3.5 million to his children and the rest of his property to Wife. The $3.5 million gift to the children*



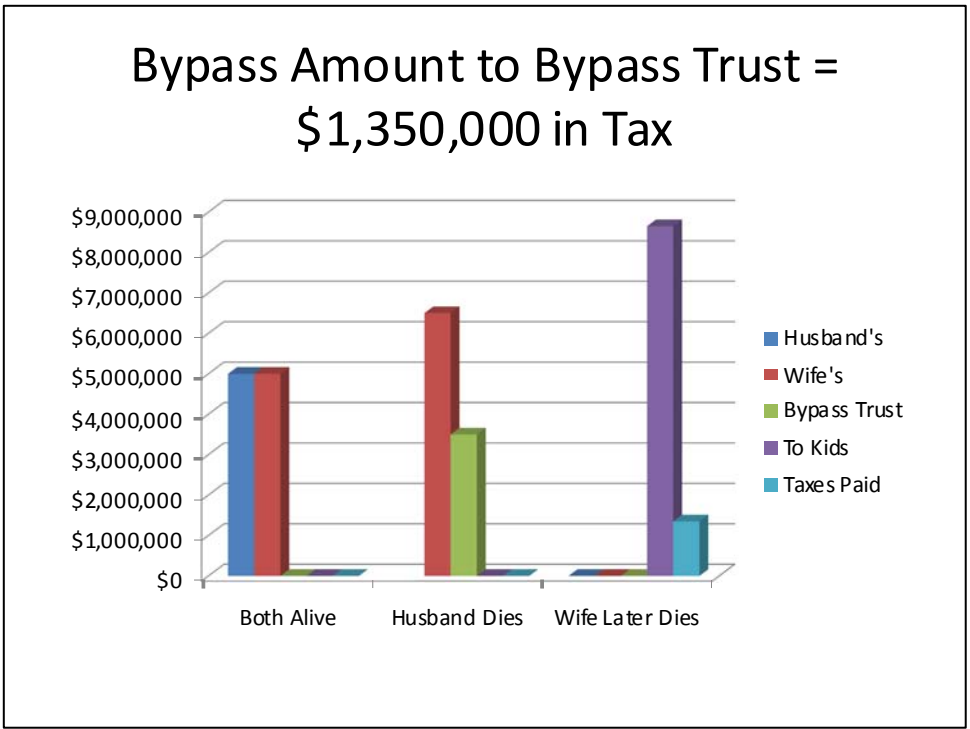
is not taxed because of Husband's tax-free amount. The other $1.5 million of Husband's property is not taxed at his death because of the marital deduction and is added to Wife's $5 million. Assuming no inflation, Wife's estate will be $6.5 million at her death. After excluding the $3.5 million tax-free amount, Wife's estate will owe approximately $1.35 million in tax – a savings of approximately $1.5 million over the tax that would have been due if Husband left all of his property to Wife.

So, if the surviving spouse does not need $3.5 million of the property owned by the first spouse to die, the married couple can save more than $1 million in tax on the transfer of assets to the ultimate beneficiaries. Of course, most married couples are reluctant to deprive the surviving spouse of $3.5 million in property.





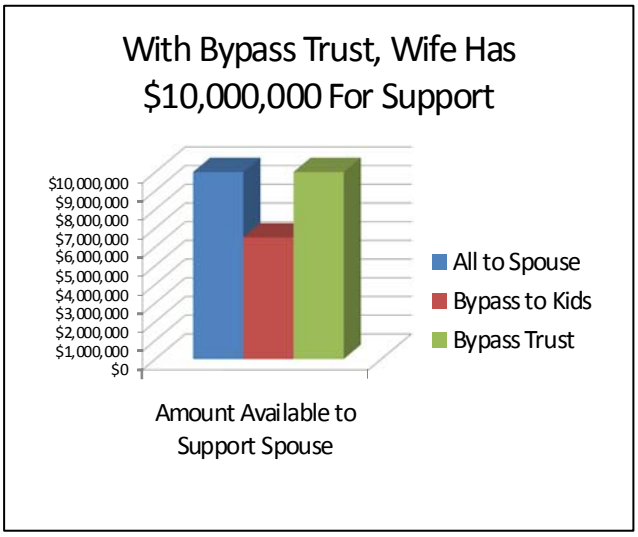
h. ***Having your cake and eating (part of) it, too.*** A bypass trust permits the tax savings available by leaving the tax-free amount to someone other than the spouse while still permitting the surviving spouse to benefit from that property. If, instead of giving all of his or her property to the surviving spouse, the first spouse to die creates a trust benefitting the surviving spouse, then the trustee can use the property in the trust to sustain the surviving spouse while permitting the property remaining in the trust at the death of the surviving spouse to pass on to other beneficiaries free of estate tax.

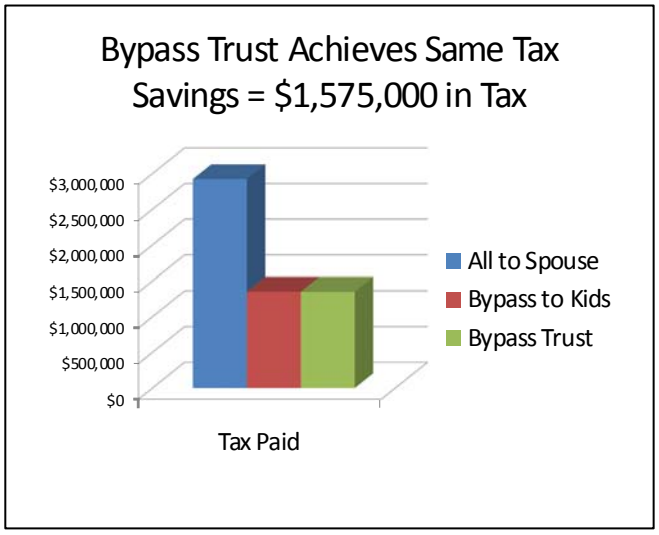


Example 4: *Husband and Wife own property worth $10 million, all of*

which is community property. Husband dies with a will leaving property worth $3.5 million to the trustee of a bypass trust and the rest of his property to Wife. The $3.5 million gift to the bypass trust is not taxed because of Husband's tax-free amount. The other $1.5 million of Husband's property is not taxed at his death because of the marital deduction and is added to Wife's $5 million. The bypass trust supports Wife for her lifetime. Assuming no inflation, Wife's estate will be $6.5 million at her death. After excluding the $3.5 million tax-free amount, Wife's estate will owe approximately $1.35 million in tax – a savings of approximately $1.5 million over the tax that would have been due if Husband left all of his property to Wife.

The estate tax effect of using a bypass trust is roughly the same as leaving the tax-free amount to the ultimate beneficiaries (usually the kids) at the death of the first death. There are restrictions on how the assets in the bypass trust can be used. These restrictions are discussed below.





2. What does it take to exclude the bypass trust from the surviving spouse's estate?

In most cases, a married person wishes to leave all of his or her property to his or her surviving spouse. (There are obvious exceptions, like second marriages.) This person may consider the use of a bypass trust in order to save his children taxes, but he or she has to become comfortable with removing such a large piece of marital wealth from the outright ownership of the surviving spouse. To reach this level of comfort, it is useful to know the extent of the rights to control and use the property in the bypass trust that can be given to the surviving spouse. Can having a bypass trust be just like owning it outright?

a. ***The key: avoiding a general power of appointment.*** A decedent's estate for estate tax purposes includes not only property owned by the decedent but also property over which the decedent holds a general power of appointment. I. R. C. § 2041(a)(2). A "power of

appointment" is the power given to a person who does not own property to say to whom the property should be given, or "appointed." The power of appointment is "general" if the holder may appoint the property to himself/herself, his/her creditors, his/her estate or the creditors of his/her estate. The power is "special" if the holder may *not* appoint the property to himself/herself, his/her creditors, his/her estate or the creditors of his/her estate.

There are three exceptions to the general power of appointment rule:

i. ***Limited by an ascertainable standard.*** If what would otherwise be a general power of appointment is limited by an "ascertainable standard," the property subject to the power will not be included in the holder's estate. I. R. C. § 2041(b)(1)(A). This exception is used when the settlor wishes to permit the surviving spouse to serve as trustee of the bypass trust. It is discussed at length below.

ii. ***Exercisable only with person with substantial adverse interest.*** If the power is exercisable only in conjunction with another person who has a substantial adverse interest in the property subject to the power. I. R. C. § 2041(b)(1)(B). If the surviving spouse must get the approval of someone with a substantial adverse interest (such as the remainder beneficiary) before being able to appoint property to himself or herself, the property subject to the power is not included in his or her estate. This exception is rarely used in bypass trusts since most settlors either choose someone other than the spouse to be the trustee or wish for the spouse to be able to exercise discretion as trustee without the consent of the remainder beneficiaries.

iii. ***$5,000 or 5% lapse of power.*** The lapse (loss due to non-use) of a general power of appointment is treated as a taxable gift by the holder unless the lapse of powers during the calendar year do not exceed the greater of $5,000 or 5% of the aggregate value of the assets out of which the exercise of the lapsed power could be satisfied. Internal Revenue Code §2514(e). For this reason, the surviving spouse can be given the power to withdraw the greater of $5,000 or 5% of the assets in the bypass trust each calendar year. The lapse of that power at the end of each calendar year will not be treated as a taxable gift. This provision was used many years ago, but it is rarely used now in cases where the surviving spouse also is the trustee of the bypass trust.

b. ***Using an ascertainable standard so the surviving spouse can be sole trustee.*** If the goal of the settlor is to give the surviving spouse the maximum power and control over the bypass trust while avoiding estate tax inclusion, he or she probably wishes to make the spouse the sole trustee of the bypass trust. This works, so long as the trustee's ability to make distributions of principal to the surviving spouse is limited to an ascertainable standard. I. R. C. § 2041; Treas. Reg. § 20.2041-1(c)(2). If the trustee's power to make distributions of principal to the surviving spouse is *not* limited by an ascertainable standard, someone other than the surviving spouse must be the trustee.

What is considered to be an "ascertainable standard in Treas. Reg. § 20.2041-1(c)(2)?"

Trust Distribution Standard	Ascertainable? (Can spouse be trustee?)
Health, education or support	Yes
Health, education, maintenance or support	Yes
Comfort, welfare and happiness	No
Support	Yes
Support in reasonable comfort	Yes
Maintenance in health and reasonable comfort	Yes
Support in his accustomed manner of living	Yes
Education, including college and professional education	Yes
Health	Yes
Medical, dental, hospital and nursing expenses and expenses of invalidism	Yes

The safest and most popular ascertainable standard is "health, education, maintenance and support," which in estate planning jargon is a "HEMS standard." This clearly qualifies as an ascertainable standard and usually offers sufficient flexibility. Additional wording expanding the power of the trustee to make distributions beyond the HEMS standard is risky because it may cause estate tax inclusion. However, it may be possible to further define the distribution standard without causing estate tax inclusion by describing the right or duty to consider other factors. Here are some provisions which may be added to the HEMS definition without causing estate tax inclusion. These provisions assume that the surviving spouse is the sole trustee:

- ***"The trustee shall not distribute any of the principal to or for the benefit of my spouse until the property in the Marital Trust is exhausted."*** This restriction is intended to assure that the assets in the bypass trust are preserved so long as the surviving spouse does not need the principal of the trust for support. It usually is found in trusts which require the payment of all income to the surviving spouse. This is a terrible provision. First, the reduced importance of the line between income and principal caused by the Uniform Prudent Investor Act (Chapter 117 of the Texas Trust Code) and the Uniform Principal and Income Act (Chapter 116 of the Texas Trust Code) makes it inappropriate to use an "all income" trust with severe principal restrictions. Second, if the settlor's goal is to assure that the principal of the bypass trust is preserved for his or her children (as may be the case in second marriage situations), making the surviving spouse the trustee

probably is a mistake. Third, this type of provision sets the surviving spouse up for a breach of fiduciary duty lawsuit by the remainder beneficiaries.

- ***"The trustee shall consider other resources available to a beneficiary in making distributions."*** This requires the trustee to consider the surviving spouse's other resources before making a distribution. If the surviving spouse is the trustee, this exposes him or her to potential liability to the remainder beneficiaries if he or she chooses to use the trust to pay for something rather than using his or her own money. For this reason, this condition is inconsistent with giving the surviving spouse maximum rights and powers over the property in the bypass trust.

- ***"The trustee may consider, but is not required to consider, other resources available to a beneficiary in making distributions."*** The surviving spouse as trustee will have an easier time meeting this standard than a mandatory standard, but this language still exposes the surviving spouse to potential liability because of the trustee's duties of loyalty and impartiality. Coupling this provision with a waiver of the duty of impartiality (discussed below) may give the surviving spouse sufficient flexibility and freedom from liability. This provision may be particularly useful if the settlor's descendants are permissive distributees of the bypass trust.

- ***"The trustee shall not consider other resources available to a beneficiary in making distributions."*** So long as the surviving spouse is the only beneficiary of the bypass trust, this provision provides flexibility and protection from liability. If the settlors' descendants are permissive beneficiaries, this provision may cause problems unless the duty of impartiality is waived.

- ***"The trustee may consider, but is not required to consider, other resources available to the beneficiaries other than my spouse in making distributions. The trustee shall not consider other resources available to my spouse in making distributions."*** This, together with a waiver of the duty of impartiality, provides maximum flexibility and protection for the surviving spouse if the settlors' descendants are permissive beneficiaries.

c. ***Using a special power of appointment so the surviving spouse has some control over disposing of what remains in the bypass trust at death.*** If the surviving spouse owned property outright, he or she could give the property during lifetime or at death to whomever he or she wished. The surviving spouse can be given the power during lifetime or at death to say who receives the property in the bypass trust, but this power must be a "special" power for the bypass trust to accomplish its tax planning objectives. So long as the settlor prohibits the spouse from giving the property to himself or herself (along with creditors, the estate and creditors of the estate), the spouse can be given unfettered power at death to dispose of property in the bypass trust. Use of a special power of appointment that can be used by the surviving spouse to direct the disposition of property during life can cause gift tax problems.

i. ***A broad special power.*** If the spouses were willing to leave all property to each other, outright and free of trust, and are using a bypass trust only for estate tax savings, then logically each spouse may wish to give the other the power to direct the property remaining in the bypass trust at death to any person or entity the surviving spouse selects. This works for estate tax purposes (so long as the surviving spouse cannot direct the property to the surviving spouse, his/her estate, his/her creditors or the creditors of his/her estate).

ii. ***A restricted special power.*** Many couples want to give the surviving spouse some flexibility in disposing of the property remaining at death, but they also want to assure that the property goes to the descendants of the first spouse to die. This is particularly true in second marriages with kids from the prior marriage. The settlor can restrict the class of persons entitled to receive property when the surviving spouse exercises the special power of appointment.

iii. ***The ultimate restriction – no special power.*** Of course, if the settlor wishes to name remainder beneficiaries of the trust and give the surviving spouse no power to change the beneficiaries or the way in which the beneficiaries receive the property (for example, outright, in trust, etc.), he or she does not have to give the surviving spouse a special power of appointment.

iv. ***Using a special power to keep remainder beneficiaries from causing trouble.*** If the surviving spouse is going to be the trustee of the bypass trust, there is no better way to keep the remainder beneficiaries (usually the settlor's children) from causing trouble during the lifetime of the surviving spouse than by giving the surviving spouse a special power of appointment at death. Even a restricted special power can provide protection from a child of the settlor's using his or her status as a remainder beneficiary to try to force an early distribution of funds by demanding trust accountings, suing the trustee, etc. However, in order to be effective, the restricted power must make it possible to appoint the trust property to someone other than the trouble-maker.

Example 5: *Husband leaves property in bypass trust with Wife as trustee and sole beneficiary. Lifetime distributions are limited by an ascertainable standard. On death, the property remaining in the bypass trust passes to the Husband's children by a prior marriage. There is no special power of appointment. Wife has the fiduciary duties of a trustee with no protection from accounting demands, lawsuits, etc., from Settlor's children. Settlor's children may be able to trouble the surviving spouse until he or she settles with the children by allowing a portion of the bypass trust property to be paid to the children prior to Wife's death. (Texas's liberal trust modification statute (Texas Trust Code §112.054) probably permits this if all parties agree.)*

Example 6: *Husband leaves property in bypass trust with Wife as trustee and sole beneficiary. Lifetime distributions are limited by an ascertainable standard. On death, Wife has a restricted special power to appoint the power among Settlor's descendants. If Wife doesn't appoint the property, the property remaining in the bypass trust passes to the Husband's children by a prior marriage. Husband has only two descendants – his two adult sons. Wife has the fiduciary duties of a trustee with limited protection from accounting demands, lawsuits, etc. – if one of the Settlor's sons causes trouble, Wife may appoint the property to his brother. However, if both*

sons team up, Wife has no protection since she cannot appoint the property to anyone other than the complaining sons. By teaming up, Settlor's sons may be able to trouble the surviving spouse until he or she settles with the children by allowing a portion of the bypass trust property to be paid to the children prior to Wife's death.

Example 7: *Husband leaves property in bypass trust with Wife as trustee and sole beneficiary. Lifetime distributions are limited by an ascertainable standard. On death, Wife has a restricted special power to appoint the power among Settlor's descendant or to charity. If Wife doesn't appoint the property, the property remaining in the bypass trust passes to the Husband's children by a prior marriage. Husband has only two descendants – his two adult sons. Wife has the fiduciary duties of a trustee with good protection from accounting demands, lawsuits, etc. Settlor's sons are unlikely to cause trouble since Wife may appoint the property to charity. Wife is unlikely to have to exercise the power to appoint to charity since sons have a disincentive to cause trouble.*

d. ***Who can be a beneficiary of the bypass trust?*** As long as a non-beneficiary is trustee, there are no restrictions on who may be a beneficiary of the bypass trust. If a beneficiary also is trustee (for example, if the surviving spouse is trustee and beneficiary), then the power of the trustee to distribute property to himself or herself as trustee must be limited to an ascertainable standard (discussed above), but other beneficiaries may be included. Many drafters like to include the descendants of the settlor, along with the surviving spouse, as beneficiaries of the bypass trust. These are called "spray" trusts or "sprinkle" trusts because the trustee may spray or sprinkle distributions from the trust among multiple beneficiaries. This works, even if the surviving spouse is the trustee, so long as the power to make distributions is limited by an ascertainable standard. However, there are a few potential problems with this approach:

i. ***Income taxation.*** If the spouse is a beneficiary and trustee, he or she may be taxed on the income of the trust even if it is distributed to another beneficiary. *See* Internal Revenue Code §678(a)(1); PLR 8211057, PLR 9227037, PLR 8939012.

ii. ***Pressure on surviving spouse to make distributions.*** If the settlor's descendants are permissive beneficiaries of the bypass trust, the surviving spouse may be pressured to make distributions to them. This risk can be reduced, but not eliminated, by making clear that the surviving spouse is the primary beneficiary and that the fiduciary duty of impartiality is waived so that the interests of the surviving spouse is preferred.

iii. ***Section 128A notices.*** Since 2007, Section 128A of the Texas Probate Code has required beneficiaries of wills to be notified by the executor. If the will makes a gift to a trust and the executor and trustee are the same person (which is likely to be the case), then the notice must go "to the person or class of persons first eligible to receive the trust income." Texas Probate Code §128A(c)(1). If a spray or sprinkle provision is used, notice must be given to each possible distributee of the trust. This may create a practical problem, since the group of potential distributees may be large. It also might be embarrassing or undesirable to give notice to distant or estranged family members.

iv. ***Necessary parties to trust litigation.*** If it becomes necessary to resort to litigation involving the trust, including a spray or sprinkle provision may make it necessary to include persons as parties that are undesirable. Section 115.011(b) of the Texas Trust Code provides that, while contingent beneficiaries designated as a class are not necessary parties to trust litigation, "a person who is actually receiving distributions from the trust estate at the time the action is filed" is a necessary party. Although it is not clear, "a person who is actually receiving distributions" may mean a person in the class of persons then entitled to receive distributions.

e. ***Following trust formalities.*** In order to assure the effectiveness of the bypass trust as a planning device, the trustee must follow the terms of the trust instrument and state law. This means that the trustee must take seriously his or her fiduciary duties as trustee, especially if the trustee also is the surviving spouse and beneficiary of the trust.

i. ***It is not "just like owning it outright."*** When explaining a bypass trust to clients, planners should avoid the temptation to say that having a bypass trust is just like outright ownership but with tax advantages. If the surviving spouse is trustee, he or she is subject to fiduciary duties which cannot be avoided. If the surviving spouse is not the trustee, he or she lacks control over the assets.

ii. ***Protecting the surviving spouse as trustee from fiduciary liability.*** The settlor may reduce the duties imposed on and the potential liabilities of the surviving spouse serving as trustee. However, it is impossible to eliminate fiduciary duties entirely. Section 111.0035 of the Texas Trust Code requires that trusts meet certain mandatory requirements.

Here are some ways to reduce the burden and risk of the trustee:

1. ***Exculpation.*** The trust instrument may provide that the trustee is not liable in damages for some breaches of fiduciary duty. Exculpation provisions have limits. A term of a trust relieving a trustee of liability for breach of trust is unenforceable to the extent that the term relieves the trustee of liability for:

a. a breach of trust committed in bad faith, intentionally or with reckless indifference to the interest of a beneficiary; or

b. any profit derived by the trustee from a breach of trust.

Texas Trust Code §114.007(a).

Just because a trustee is relieved of liability with respect to an act does not mean the trustee is authorized to take the action. For example, a trustee relieved of liability in damages for self-dealing is not authorized to engage in self-dealing (unless the trust instrument also waives the duty of self-dealing). While the trustee may not have to pay damages for a breach of trust, he or she still may be removed by the court, enjoined, etc. If desired, and unless prohibited by Section 111.0035 of the Texas Trust Code, the settlor may relieve the trustee from a duty or restriction. Texas Trust Code §114.007(c). Therefore, to provide the trustee with maximum

protection, the settlor not only should exculpate the trustee from liability but also should relieve the trustee from certain specific duties.

2. ***Waive the duty of impartiality.*** A trustee has a duty to treat beneficiaries impartially. If the trustee also is a beneficiary, this can present problems. The settlor may protect the trustee/beneficiary by waiving the duty of impartiality and by providing that, in any question regarding the administration of the trust, the interests of that beneficiary shall prevail over the interests of other beneficiaries.

3. ***Waive the duty to diversify.*** Since the Texas Uniform Prudent Investor Act became effective in 2004, the trustee has a duty to diversify investments unless the trust instrument waives that duty or another statutory exception applies. It is likely that a married couple's holdings will not meet the diversification standard imposed on trustees. The trust instrument can provide that the trustee is relieved from the duty to diversify and is not required to diversify investments.

4. ***Authorize self-dealing.*** A trustee has a duty of loyalty and is required to restrain from self-dealing. It is likely that the surviving spouse as trustee will need to take actions which would be considered self-dealing. The trust instrument can authorize the trustee to engage in self-dealing, so long as the terms of the self-dealing transaction is fair.

5. ***Give the spouse the right to use and occupy trust property even if it generates no income or gain.*** Even without special authorization in the trust instrument, a trustee has the power to permit a beneficiary to use or occupy a piece of trust property as a residence. Texas Trust Code §113.022. Nevertheless, to be safe, the settlor may provide that the surviving spouse can use or occupy any trust property without paying rent or other compensation for its use and that the trustee may hold that property without regard to diversification or the likelihood of appreciation in value.

6. ***Take away the right of remote remainder beneficiaries to demand an accounting.*** Under Section 113.151 of the Texas Trust Code, any beneficiary may demand an accounting. Section 111.0035(b)(4)(A) permits the settlor to provide that the only beneficiaries who can demand a statutory accounting are those who are then entitled or permitted to receive trust distributions or who would receive a distribution from the trust if the trust terminated at the time of the demand. Section 111.0035(c) permits the settlor to limit any common law duty of the trustee to keep remote beneficiaries and beneficiaries under age 25 informed. (This is another reason not to use a spray or sprinkle trust – if remote descendants are permissible current beneficiaries, their right to demand an accounting cannot be taken away.)

7. ***Do not impose additional duties to account.*** Many trust instruments contain boilerplate provisions requiring the trustee to give periodic accountings. These are traps for the spouse/trustee, since most individual trustees ignore this requirement and only give accountings when demanded.

8. ***Permit trustee compensation.*** The boilerplate in some trust instruments prohibits a trustee who also is a beneficiary from receiving compensation for service

as trustee. Permitting a trustee/beneficiary to receive compensation provides more flexibility. If desired, the settlor may provide that no trustee is required to accept compensation for service as trustee.

9. ***Give the surviving spouse the power to appoint co-trustees and designate successor trustees.*** The settlor can authorize the trustee to appoint one or more co-trustees. This may help avoid liability for a self-dealing transaction since the neutral co-trustees may authorize the transaction. The settlor can authorize the trustee to designate or appoint his or her successor trustees should he or she resign, become incapacitated, die or be removed. The settlor can provide that the successor trustees designated by the surviving spouse take precedence over the successors named by the settlor. This gives the spouse/trustee an option to resign in favor of a trusted person and removes the remainder beneficiary's incentive to gain control of the trust by getting a court to remove the spouse/trustee.

10. ***In terrorem provision?*** The settlor may insert a "no contest" provision in the trust instrument. However, this type of provision is unlikely to be helpful to protect the spouse from fiduciary liability. A provision in a trust instrument that would cause a forfeiture of or void an interest for bringing a court action is unenforceable if probable cause exists for bringing the action and the action was brought and maintained in good faith. Texas Trust Code §112.038. A trust provision that voided a beneficiary's interest in a trust merely for bringing an action against the trustee for breach of fiduciary duty probably is unenforceable. *See* Texas Trust Code §111.0035(b)(5) (no trust provision may take away the power of a court to take action or exercise jurisdiction with respect to a trust). While a provision such as this may provide a modest amount of protection for the surviving spouse serving as trustee, a no contest clause is a blunt instrument that can do more harm than good and should be avoided except in extraordinary cases.

f. ***Consider making bypass trusts QTIP-able for persons dying in 2010.*** The estates of persons dying in 2010 are not subject to the estate tax, but these estates are eligible for only $1.3 million in stepped-up basis. Property left to a surviving spouse, either outright or in a trust meeting QTIP requirements, is entitled to an additional $3 million in basis step-up. For this reason, consider making the bypass trust eligible to meet QTIP requirements for persons dying in 2010. This makes it possible for the bypass trust to fulfill its primary function – estate tax savings if the surviving spouse dies when there is an estate tax – while assuring the maximum step-up in basis for the estate of the spouse dying in 2010.

The most significant changes needed to make the bypass trust QTIP-able are:

- Making the surviving spouse the sole beneficiary during his or her lifetime.
- Providing that all of the income of the bypass trust will be distributed to the surviving spouse in convenient installments no less frequently than annually.
- Permitting the surviving spouse to require the trustee to invest the trust property in income-producing investments.

These requirements are not onerous. Distributing all of the income of the bypass trust is inconsistent with maximum estate tax savings, but this may be a small price to pay for the basis step-up if the first spouse dies in 2010.

3. ***Funding bypass trusts.***

In order to create a bypass trust, the trust instrument must provide a way for the property passing into the trust to be identified. There are three ways to do this:

- Naming specific assets that will pass into the trust.
- Providing that assets disclaimed by the surviving spouse pass into the trust.
- Including a formula clause.

a. ***Funding by naming specific assets.*** The trust instrument may provide that a particular asset shall pass to the trustee of the bypass trust. The problem with this approach is that the value of the asset as of the date of the settlor's death is hard to guess. If the asset is worth less than expected, the bypass trust will be underfunded. If the asset is worth more than expected, the bypass trust will be overfunded. An underfunded bypass trust means that more estate tax may be imposed when the surviving spouse dies. An overfunded bypass trust is even worse – unless the bypass trust qualifies as a QTIP trust, estate tax will be due when the first spouse dies. For this reason, this method is rarely used.

b. ***Funding by disclaimer.*** The trust instrument may provide that all property passes to the surviving spouse, except that any property disclaimed by the surviving spouse instead passes into the bypass trust. A disclaimer is a means by which someone entitled to receive property can refuse to accept it, causing it to pass to someone else. *See* Texas Probate Code §37A; Texas Trust Code §112.010; Internal Revenue Code §2518. A special rule applying only to spouses permits the spouse to disclaim property into a trust of which the spouse may be a beneficiary. Internal Revenue Code §2518(b)(4)(A).

i. ***Advantages of disclaimer funding method.*** The key advantage of using a disclaimer to fund the bypass trust is that the surviving spouse can wait until after the death of his or her spouse to determine whether or not to create the bypass trust and how much property to place in the trust. The other methods require the bypass trust to be created and specify which assets (or the value of assets) must go into the trust. The ability to make a post-mortem decision about funding the bypass trust is particularly advantageous in times when the tax laws are uncertain or when the size of the estate is likely to vary greatly. It also is a good way to hold a bypass trust in reserve for a couple whose current net worth does not justify a trust but who may need a trust if their net worth grows before a new will is prepared.

ii. ***Disadvantages of disclaimer funding method.*** There are several reasons why relying on a disclaimer to fund the bypass trust may be a bad idea.

1. ***Acceptance of benefit.*** A disclaimer cannot be made if the person disclaiming has accepted the interest or any of its benefits. Internal Revenue Code §2518(b)(3). If the surviving spouse mistakenly takes control of an asset prior to executing the disclaimer, the ability to use that asset to fund the bypass trust may be lost.

2. ***9-month requirement.*** The disclaimer must be made within 9 months of the decedent's death. Internal Revenue Code §2518(b)(2). A spouse who is asleep at the switch may fail to disclaim by the deadline.

3. ***Reliance on spouse to do the right thing.*** A disclaimer-funded bypass trust only works if the surviving spouse disclaims. Thus, the disclaimer method relies on the ability and willingness of the surviving spouse to act. A grieving spouse may be unable or unwilling to disclaim within the time allotted. The guardian of the estate or agent under a statutory durable power of attorney signed by a spouse who later becomes incapacitated may disclaim on the spouse's behalf, but either a guardianship or a power of attorney must be in place. The surviving spouse with stepchildren as remainder beneficiaries is unlikely to disclaim since doing so exposes him or her to possible fiduciary liability solely in order to save the stepchildren estate taxes.

4. ***No special power of appointment.*** The surviving spouse cannot be given a special power of appointment over a trust which is funded with disclaimed property. As discussed above, a special power of appointment is one of the key ways in which the surviving spouse can be protected from interference by the remainder beneficiaries. The inability to use a special power makes a disclaimer trust useful only in situations where the chance of trouble from remainder beneficiaries is remote.

c. ***Funding by formula clause.*** Because of the disadvantages of the other two methods, most bypass trusts are funded by means of a formula clause. The drafter attempts to define the amount of property passing into the bypass trust by reference to the maximum amount that can pass estate-tax free. This allows a gift of the optimal amount and provides flexibility to deal with changes in asset value and tax-free amounts. This simple concept is made more difficult because there are a variety of ways to define the gift.

i. ***Which gift is defined – bypass or marital?*** The formula clause divides the estate into the bypass portion and the marital deduction portion. The bypass portion goes into the bypass trust and must not exceed the available tax-free amount. The marital deduction portion either goes outright to the surviving spouse or into the marital trust in order to assure that any excess value over the tax-free amount qualifies for the marital deduction.

1. ***The gift to the bypass trust is the pre-residuary gift.*** In some cases estate planners make the formula measure the bypass portion of the estate. This is the most straightforward and easiest to understand. In essence, the trust instrument says, "put the largest amount of property that can pass estate tax free into the bypass trust and let the rest of the property go to the surviving spouse (or into the marital trust)." If the tax-free amount at death was known, this clause could simply say, for example, "put $2,000,000 in the bypass trust." However, the tax-free amount is a moving target – since 2000, it has been $675,000, $1,000,000,

$1,500,000, $2,000,000, $3,500,000 and an unlimited amount. Also, other factors may affect the size of the tax-free amount at the time of death, including lifetime gifts, gifts passing free of the trust instrument (such as life insurance or IRA benefits), and other more technical factors. For this reason, more elaborate formula clauses are used.

2. ***The marital gift is the pre-residuary gift.*** In other cases estate planners make the formula measure the marital gift. This is more confusing and harder to explain to clients. In essence, the trust instrument says, "make the gift to my spouse the smallest amount possible while not triggering an estate tax, and let the rest of the property pass to the bypass trust." As is the case when the pre-residuary gift is the gift to the bypass trust, more elaborate clauses are necessary to deal with variables. Using this approach, the planner must explain why the trust instrument says the surviving spouse is getting the smallest amount possible, rather than explaining that the bypass amount goes to the bypass trust and everything else goes to the surviving spouse.

ii. ***Income tax effects of funding bypass trusts.*** If the bypass gift and the marital gift could be funded immediately at the moment of death, there would be no income tax effect of funding the gifts. All assets in the decedent's estate get a basis step-up at death, so any transaction or swapping that occurs at the moment of death cannot incur a capital gains tax.

Unfortunately, it usually is impossible to fund the gifts at the moment of death. This means that, unless the entire estate is cash, some assets will either increase in value or decline in value between the date of death and the date of funding. If the gift is of a pecuniary amount (for example, if the formula clause determines that $2,000,000 should be distributed to the trustee of the bypass trust), the gift may be treated as if it was a sale, causing gain to be recognized. The residuary gift does not run the risk of causing gain to be recognized. The problem of possible realization of gain on funding of the bypass and marital gifts has resulted in a variety of formula approaches to be used.

iii. ***Pecuniary formulas.*** Most formula clauses used in Texas are pecuniary formulas intended to result in determining a specific dollar amount of the gift. In order to work, a pecuniary formula must be one of the following:

1. ***True worth formulas.*** This approach, often called a "date of distribution" formula, is the most common one used in Texas. If no contrary provision is included in the trust instrument, this approach applies in Texas. Texas Probate Code §378A(b). Under this approach, assets used to fund the pecuniary gift are valued as of the date of funding, not the date of death. The disadvantage of this approach is that a taxable gain will be recognized if any of the assets used to fund the pecuniary gift increase in value between the date of death and date of funding. An advantage of this approach is that it is straightforward and easy to apply. Only those assets used to fund the pecuniary gift must be revalued on the date of funding. Another advantage is that it gives the executor or trustee the most flexibility in choosing which assets to use in funding the gift. Also, in appropriate cases it allows the amount of the pre-residuary gift to be frozen, shifting all of the gain or loss of the estate to the residuary bequest.

2. ***Minimum worth formulas.*** Using this approach, the assets used to fund the pecuniary gift will be valued at their estate tax values or their date-of-funding values, whichever is lower. This approach avoids incurring a taxable gain on funding. This approach sticks the residuary gift with all of the depreciated assets. This approach is not used often in Texas.

3. ***Fairly representative formulas.*** This approach allows the executor or trustee to fund the pecuniary gift using date of death values but requires the executor or trustee to select assets which are "fairly representative" of the appreciation and depreciation in the estate. Texas law imposes a fairly representative standard if the trust instrument requires date of death values to be used in funding the pecuniary gift. Texas Probate Code §378A(a). The advantage of the fairly representative approach is that no taxable gain is triggered upon funding the pecuniary gift. The disadvantage is the need to value all of the assets of the estate to determine that the distribution if fairly representative of appreciation and depreciation in the estate.

iv. ***Fractional formulas.*** Instead of defining the bypass gift as a pecuniary amount, the trust instrument may define it in terms of a fraction of the residuary estate. For example, if the residuary estate is $3,000,000 and the available tax-free amount is $2,000,000, the fractional formula clause would cause 2/3 of the residuary estate to pass to the bypass trust and 1/3 of the residuary estate to the spouse. The formula either can require every asset of the estate to be fractionalized or it can permit the executor to "pick and choose" the assets to fund the two gifts by making non-pro-rata distributions. The advantage of fractional formulas is that a taxable gain can be avoided upon funding the gifts. The disadvantage is having to compute this fraction when the estate is distributed. Fractional formulas are rarely used in Texas.

d. ***Problems with formula clauses for persons dying in 2010.*** Formula clauses were drafted in anticipation that there will be a tax-free amount for estate tax purposes. What happens when, as in 2010, the tax-free amount is unlimited? It depends upon the wording of each formula clause. Most clauses are likely to cause the entire estate (after specific gifts) to pass into the bypass trust. However, clauses often mention specific concepts and provisions from the estate tax statutes, and these concepts do not apply in 2010. For example, what happens if the formula clause is tied to the unified credit as stated in Section 2010 of the Internal Revenue Code? There is no Section 2010 for persons dying in 2010.

Florida, Georgia, Indiana, Maryland, Nebraska, Tennessee, Utah, Virginia, Washington and Wisconsin have enacted statutes providing that, in wills of decedents dying in 2010, a clause referring to certain estate tax and GST terms will be construed as referring to the estate and gift tax laws which were in effect on December 31, 2009. In these states, a formula tied to the tax-free amount would be tied to $3,500,000. The Texas Legislature has not met since this problem surfaced, so there is no construction statute in Texas.

e. ***Use of a funding memorandum.*** The decisions made when funding the bypass gift and the marital gift when the first spouse dies affect the estate of the surviving spouse. In order to record the steps taken when these gifts are funded, it is a good idea to use a

funding memorandum. This document is an internal record of decisions and events. It should recite the process the executor or trustee followed in deciding which assets funded which gifts and it should include a spreadsheet explaining the allocation of assets. In addition to being useful to recall what happened at the time of the surviving spouse's death, the memorandum also is handy for explaining the process to the client and for providing written instructions to financial institutions about division and allocation of assets.

4. ***Administering bypass trusts.***

The trustee of a bypass trust is a fiduciary and must administer the trust in accordance with fiduciary principles.

a. ***Avoid commingling assets.*** The bypass trust must have its own taxpayer identification number. Its accounts at financial institutions must be kept separate from the trustee's personal accounts.

b. ***Keep good records.*** The trustee may be required to provide an accounting of the trust, so the trustee should keep assets segregated and should keep good records. Unlike personal tax records, trust records should be retained until after trust termination.

c. ***Get good tax help.*** A Form 1041 trust income tax return will be required for the bypass trust. The trustee should retain a certified public accountant who is familiar with trust income tax rules in order to assure proper tax treatment of trust transactions and to assist in making decisions about distributions.

d. ***Be able to prove the exercise of discretion.*** As trustee, the surviving spouse will be empowered to many decisions requiring the exercise of discretion. A failure to exercise discretion may be a breach of trust. For example, if the trustee is required or permitted to make distributions of income and principal to the surviving spouse based on the health, education, maintenance and support needs of the surviving spouse, the trustee needs to be able to prove that those needs were analyzed. The trustee should establish policies about how certain decisions are made. These policies should be followed and a written record should be kept.

e. ***Act in good faith.*** As trustee, the surviving spouse must deal with the remainder beneficiaries in good faith and deal with them fairly. The trustee should not send punitive emails and letters; rather, he or she should use a civil tone even if the remainder beneficiaries do not. When in doubt about how to respond or act, the trustee should seek the advice of an attorney.

5. ***Dealing with unfunded or broken bypass trusts.***

It often happens that the surviving spouse never funds the bypass trust. Once the decedent's will is probated and the inventory, appraisement and list of claims is filed, the surviving spouse as executor may do nothing else. Often family members learn of this lapse only after the death of the surviving spouse.

All is not lost. If the bypass trust was to be funding using a formula clause, then creation of the trust was mandatory and the failure to fund the bypass trust is a breach of fiduciary duty, not a failure of the trust. Mickey R. Davis of Houston addresses this issue in "Funding Unfunded Bypass Trusts," presented to the 30th Annual Advanced Estate Planning and Probate Course in 2006. Some or all of the intended estate tax savings still may be achieved.