By: Lainie R. Fastman
Law Firm of Hall & Hall, LLP
Staten Island, New York
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THE BY-PASS OR CREDIT SHELTER TRUST

Notwithstanding uncertainty about estate taxes, making long term planning difficult, many have commented about the continued viability of the by-pass or credit shelter trust. Accordingly, it may be useful to explore, in some detail, how it is arrived at; what its properties are and how one avoids the myriad mine fields it may present.

FEDERAL OR STATE EXEMPTION AND OTHER CONSIDERATIONS

To recapitulate briefly, the basis of the by-pass or credit shelter trust Will is found in the Internal Revenue Code which permits an estate to deduct on the estate tax return the value of assets which pass to the surviving spouse. [1] Thus, when a testatrix provides that her Executor is to set aside, in a trust, the amount exempt from estate tax, and the balance is to be paid to her spouse, she has created an estate tax free estate.

The trust may be created by a formula clause like the following:

> "I give and bequeath to my Trustees, hereinafter named, a sum equal to the maximum amount, if any, by which my federal taxable estate (determined without regard to this Article of my Will) may be increased without causing an increase in federal estate tax payable by reason of my death...."

Should one define its parameters as embracing the federal exemption, as above, or the New York State exemption? Uncertainty surrounding the current federal estate tax statute is not the only issue to consider. Two couples owning assets having identical value

may, nevertheless, live under completely different financial circumstances. One couple may own a modest home and possess other, substantially liquid assets. Another couple may have tied up in their family home a goodly portion of their fortune, a non-income-producing asset, and much of the balance consists of the husband's IRA. The IRA–subject to mandatory distributions–will be greatly diminished by income taxes over time. Thus, the surviving spouse may be left with insufficient flexibility if the bulk of the assets are held in trust upon the death of the first spouse. Counsel's recommendation depending on these circumstances may differ.

The outright gift to the spouse can be created as a pre-residuary bequest (results: a pecuniary gift) and the by-pass trust is then the residuary (result: any growth during administration enures to the trust). [2] The distinction, however, is far from clear cut. In a Will involving a pecuniary legacy to the spouse, cases do permit the spouse to share in appreciation. [3]

In deciding whether to create the by-pass trust effective without any action by the surviving spouse, remember to consider inter vivos gifts made by the testator. Has the unified credit been exhausted during the testatrix's life time? If so, the trust will not be funded. Generally, formula clauses creating the by-pass trust take the possibility of exhaustion of the unified credit into account:

> "I direct my executors to set apart a sum equal to the largest amount, if any, that can pass free of federal estate tax.....reduced by all other bequests and devises under my will for which no marital or charitable deduction is allowable and any property passing outside my will included in my gross estate for federal estate tax purposes...." (*Be sure to purge the formula clause of language referring to a "credit for state death taxes. There is no such credit, rather, a deduction is allowed on the federal estate tax return for state death taxes.)* [4]

Many a Last Will is extant which creates the by-pass trust based on the federal exemption when it was substantially less than the present exemption of $5,000,000.00 (in 2011 and 2012), or even less than the currently set exemption effective on January 1, 2013. ($1,000,000.00) [5]

If, given all the circumstances, a by-pass trust is selected with reference to the New York State exemption only, but there are substantial assets exceeding this amount, some practitioners recommend a so-called "gap" trust, which will be funded with the difference between the New York State and federal exemptions. This trust may be fashioned as a Trust which will qualify as QTIP under the New York Statute and thus is not subject to New York State estate tax [6], nor will it be taxable in the federal estate tax return of the surviving spouse, as the decedent's total assets did not exceed the decedent's federal exemption and no federal estate tax return need be filed. [7]

Generally, the by-pass trust provides that all the income is payable to the surviving spouse during his life time. Furthermore, the Trustee/spouse is often granted the power to withdraw $5,000.00 per year or five percent (5%) of the trust property over which the power is exercisable. This power, commonly known as the "five and five" power, will not cause the trust property to be taxed in the estate of the surviving spouse. [8]

Care should be taken not to grant the surviving spouse who serves as sole Trustee a power of appointment over the trust property. Assume, for example, that the Trustee/spouse has the power to make discretionary distributions to the trust beneficiaries consisting of spouse herself and the parties' children. The decedent has granted spouse/Trustee a general power of appointment which results in the property being

potentially taxable in the surviving spouse's estate. [9] If the power holder spouse exercises the power and distributes property to a beneficiary, she has made a taxable gift. [10]

DISCLAIMER ACTIVATED BY-PASS

Another approach to dealing with uncertainty is the disclaimer Will. Testator bequeaths his entire estate to his spouse and provides that if the spouse disclaims a portion or the entire estate, such disclaimed assets fund a by-pass trust waiting in the wings.

A disclaimer must be qualified pursuant to the Internal Revenue Code and New York State law and must be made within nine (9) months of testator's death. [11]

Remember that, in deciding what assets to disclaim, the surviving spouse may consider the interest passing to her from property held jointly (or in tenancy by the entirety) with the deceased spouse. The survivor's interest in jointly held assets is one-half of the total value of the interest. The interest in the survivorship is not created until the death of the first joint tenant and a disclaimer within nine (9) months of death is thus timely. [12]

A surviving spouse may disclaim other property passing to him by operation of law, such as insurance proceeds payable to him, or his interest in retirement benefits. In both instances, if there are named alternate beneficiaries, the interest would pass to such named beneficiary. Accordingly, the attorney draftsman must ensure that beneficiary designations are coordinated with a disclaimer provision in the will. Example:

> Primary beneficiary, my wife, Jane. Alternate beneficiary - if my wife, Jane, survives me, but disclaims any part or all of her interest in --------, then the John Smith Family Trust created in my Last Will & Testament, dated----------. etc.

Clearly, no disclaimer may be contemplated if the estate tax picture at the time of the first spouse to die does not make it desirable as a tax avoidance technique. Some attorneys opine that they have never encountered a surviving spouse who willingly disclaims. My experience does not confirm this view. Where husband and wife have a marriage of long duration and there are children from that marriage, the surviving spouse is well motivated to save ultimate estate taxes payable upon her death and make the disclaimer. A disclaimer Will may not be suitable for a second marriage where the couple do not have children in common. [13]

There are advantages to the disclaimer Will. The disclaimer activated by-pass trust may be funded with an amount less than the unified credit amount, a flexibility not present in the standard formula created by-pass trust, as, typically, the disclaimer Will provides that the surviving spouse may disclaim "such amount or such portion" of the legacy otherwise passing to the spouse.

In drafting a disclaimer Will, counsel should carefully consider the terms of the by-pass trust. Are there non-permissible powers of appointment lurking in the recipient trust which may cause the trust property to be included in surviving spouse's estate, thereby completely defeating the purpose of the plan and, furthermore, causing the disclaimer to be non-qualified? Some attorneys like to provide flexibility to the surviving spouse and include in the by-pass trust a limited power of appointment:

> "Upon the death of my husband, Jim, my Trustee of the Sally Quakes Family Trust is directed to distribute the Trust estate to such of my children, as my husband, Jim, in his Last Will & Testament duly admitted to probate, shall direct..."

(*or words to that effect*). Such power may not be contained in the recipient trust of

disclaimed property. [14] The reason for this is as follows: Special rules are in place for disclaimers by a surviving spouse with respect to the property derived from the deceased spouse's estate. The disclaimer is qualified if the interest disclaimed passes without direction on the part of the surviving spouse either to the surviving spouse himself or to another person. If, however, the surviving spouse, upon disclaiming, retains the right to direct the beneficial enjoyment of the property, the disclaimer is not "qualified." [15]

In the above example, husband, Jim, has the right to direct which of the couple's children will inherit. If, on the other hand, the recipient by-pass trust were to provide that husband, Jim, will get all the income from the trust during his life time, or, say, twenty thousand dollar ($20,000.00) per year, the disclaimer is qualified. Husband's, Jim's, limited power of appointment to leave the trust property to those of the couple's children he desires could have been retained in the recipient trust by providing that if the surviving spouse were to disclaim assets, the by-pass trust splits into two trusts, one with the power of appointment and the second, recipient of the disclaimed assets, without the power of appointment. [16] It would seem, that the problem may also be addressed by the spouse also disclaiming the power of appointment in the recipient trust.

Similarly, if the Trustee/spouse can discharge her duty of support of minor children by means of a power in the recipient trust (e.g. surviving spouse as Trustee of by-pass trust authorized to pay for the support of the couple's minor children), such exercise would be deemed an exercise in favor of spouse's "creditors" and therefor a general power of appointment, resulting in the inclusion of the property in the surviving spouse's estate. [17] In general, if a power is exercisable only with the consent of an adverse party (e.g. a child

remainderman - a person whose interests would be adversely affected by the Trustee/spouse's exercise of the power), the power will not be deemed a general power of appointment. (A general power of appointment should be avoided at all cost in any by-pass trust, whether or not the trust is a recipient trust of a possible disclaimer, as the estate tax purpose of creating a by-pass trust is completely defeated).

The statute specifically excludes from its application a power surviving spouse could exercise limited by an "ascertainable standard". Provisions may be included granting the Trustee/spouse the authority to invade the trust for her health, support, education and maintenance. It is important not to get too fanciful in describing spouse's benefits under this provision, but to adhere to the language approved in the Internal Revenue Code and insure that there is an "ascertainable standard" for the Trustee/spouse to follow. [18] Examples set forth in the Regulations amply demonstrate how easy it is to bring about an unhappy result. A power that Trustee/spouse may pay principal to himself for "support in reasonable comfort" is limited to an ascertainable standard, but one to distribute for his "comfort" is not deemed limited to an ascertainable standard. Inadvertently, the Trustee/spouse has then been granted a power of appointment, causing the by-pass trust property to be taxable in his estate. [19] . A recent case is instructive. The by-pass trust in Lester Chancellor's Last Will & Testament provided that his wife, Ann, and her Co-Trustee, a local bank, could invade the trust principal for Ann and the parties' descendants, for

> "the necessary maintenance, education, health care, sustenance, welfare or other appropriate expenditures needed...taking into consideration the standard of living to which they are accustomed..." [20]

Although the estate prevailed in its position that Trustee/spouse was bound by an ascertainable standard, the estate was embroiled in litigation and the decision could have easily gone the other way.

SAME-SEX COUPLES; PORTABILITY

Although New York State now recognizes same-sex marriage, and the estate of the deceased same-sex spouse may be entitled to a marital deduction for New York estate tax purposes, the deduction does not apply for federal estate tax purposes. Accordingly, the classical by-pass trust principles may not always be helpful in planning for same-sex spouses. This does not obviate all planning opportunities, but a discussion is beyond the scope of this article.

Similarly, we did not address the current so-called "portability" provision of the 2010 amendments to the federal estate tax statute, permitting the surviving spouse to make use of the unused portion of the deceased spouse's exclusion amount. Unless the statute is amended, by January 1, 2013, the portability provision is no longer effective, although the President's proposed budget seeks to make portability permanent. Predictions about what actually will happen here are akin to divination.

IMPLEMENTING THE TRUST

Clients, (and occasionally their lawyers), have a hard time envisioning the implementation of the by-pass trust, that, we hope, has been decided upon after considerable reflection and drafted with care. The trust does not spring into being by virtue of the probate of the Will (or by virtue of decedent's having created it in his inter vivos trust). It must be funded. Counsel must obtain a tax ID number from the IRS, which can

now be done online. Important decisions about funding must be made. We have already determined the value of the assets funding the trust, but how to select the precise components? If the decedent's property is mostly liquid, the decision is simple. Often, however, this is not the case. If the by-pass trust provides for a life estate to the spouse in the trust property and the parties' home, in which the surviving spouse resides, was in the deceased spouse's name, and if the surviving spouse wishes to live in the house, funding the trust with the house may be an excellent choice. A deed from the Executor to the Trustee should be executed. This is not a case where no deed is required because the probate of the Will is evidence of the vesting of specifically devised real estate [22]

The fact that the trust assets have obtained the decedent's date of death value as their basis, may be another factor in the Executor's decision. [23] In any event, funding should take place as soon as practicable. An account or accounts should be created bearing the title of the trust and the name of the Trustee. Although a receipt and release is required if the presumptive remaindermen of the trust are persons under disability (infants, incarcerated persons, incapacitated persons), typically, the couple's children are adults. Nevertheless, it would be useful for the Executor/spouse/Trustee to present them with an informal accounting after the administration of the estate is completed, whether or not it would otherwise be required. The adult children should sign off on the account; their signatures duly acknowledged. Counsel may consider an advisory letter to the children explaining how the estate was administered; what the future administration of the trust entails; what decisions the Trustee/spouse is entitled to make; when the remainder will be distributed, and so on.

It is essential for the Trustee to keep excellent records. The Trustee should be armed with counsel's advisory letter concerning his or her fiduciary duties. It is useful for the Trustee/spouse to send a copy of the fiduciary income tax returns, as well as all 1099's and end of year bank statements to the presumptive remaindermen. This may avoid an action by a disgruntled remainderman once the surviving spouse has died.

JOINT REPRESENTATION

Counsel may have been the attorney draftsman. Both spouses' Wills contain the by-pass trust. Both spouses will be involved in planning conferences. On occasion, this can present a problem. You may have heard: "My wife will do as I think best...," or "... My wife does not need to be involved..." or other choice comments. Counsel should take care that both spouses fully understand the concepts discussed and are on board with the plan. Consider a letter addressed separately to each spouse with a requests to sign. If there are intractable problems, counsel may advise one or both of the parties to obtain separate attorneys. In the alternative, continue to represent one of the spouses and advise the other to seek his or her own attorney.

CONCLUSION

Finally, consider the possibility of having the by-pass trust continue after the surviving spouse's death, not only for the couple's minor children, but also in the form of a Supplemental Needs Trust for an incapacitated beneficiary; as a recipient for proceeds of insurance on the life of the surviving spouse but owned by an independent insurance trust; as a support trust for an improvident beneficiary. Special drafting issues of the by-pass trust are then applicable. The possibilities are endless. Remember, a trust provides

protection from creditors; shields the assets from the claims of the spouse of a divorcing beneficiary; can purchase assets held for the benefit of a beneficiary, but which may not be owned by the beneficiary. This brief discussion merely touches on some of the issues involved in drafting and administering an old war horse of the married couple's Last Wills, the by-pass or credit-shelter Trust.

Endnotes

1. IRC §2056.

2. See, in general, EPTL §11-2.1, c.f. EPTL §2-1.9. Executor may satisfy pecuniary bequests with assets valued on date of distribution.

3. , e.g. Matter of Bush, 2 AD2d 526, aff'd 3 NY2d 908 (4th Dept. 1956); Matter of Leonard, 45 Misc.2d 534, 257 NYS2d 409 (N.Y. Surr. Ct. 1965).

4. Where state death tax is a "deduction" rather than a "credit," the state death tax need not be paid out of the sheltered assets. For a problem with shelter formulas, see Matter of Ettinger, 149 Misc.2d 308 (Sur. Ct. New York Cty., 1990).

5. Tax Relief, Unemployment, Insurance Reauthorization and Job Creation Act of 2010 (Pub. L. 111-312; 124 Stat. 3296, 12/17/2010).

6. NYS Dept. of Taxation and Finance, TSB-M-10(1)M; c.f. Laurence Keiser, NYSBA Trusts and Estates Law Section Newsletter, Summer 2011, Vol. 44, No. 2. Separate New York State QTIP election permissible where no federal return is required to be filed.

7. c.f. Catherine Grievers Schmidt and Jill Choate Beier, NYLJ Jan. 26, 2009.

8. In general, see IRC §2041(b)(2) and 2514(e).

9. Reg. §20.2041-1(b)(1).

10. Reg. 25.2514.

11. IRC §2518; EPTL §2-1.11.

12. IRC §2518.

13. There are many options to deal with that situation. Consider, e.g., creating, in the

planning stage, upon consent/waiver of the second spouse, a marital trust, in which the Executor may decide what portion to qualify for the marital deduction as a marital trust pursuant to IRC §2056 (b)(7); the balance, in fact, to constitute a by-pass trust.

14. IRC §2518(b)(4); Reg. §25.2518(e)(2).

15. Reg. 25.2518-2(e)(2).

16. See, Alan S. Gassman and Christopher J. Denicolo, Estate Planning, June 2011, vol. 38, No. 6.

17. IRC Reg. §20.2041-1(c)(1).

18. IRC Reg. §20.2041-1 (c) (2).

19. For a good discussion, see Alexander A. Bove, Jr., "Powers of Appointment: More (Taxwise) Than Meets the Eye," Estate Planning, Vol. 28, No. 10

20. Estate of Chancellor v. Commissioner, T.C. Memo. 2011-172. No. 7973-09, 7/14/11.
21. For helpful hints, see Nicole M. Pearl and Carolyn S. McCaffry, "Effect of Same-Sex Marriage Laws on Estate Planning," Estate Planning, January 2012.

22. Upon the decedent's death, title to real property vests in decedent's distributees, or in his devisees if he dies testate and tile "descends immediately upon death." In re Frank's Will, 123 N.Y.S2d 452 (Sur. Ct. Erie Cty., 1953); c.f. Waxson Realty Corp. v Rothschild, 255 N.Y. 332 (1931).

23. IRC §1014.

Lainie R. Fastman is a partner in the Law Firm of Hall & Hall, Staten Island, New York. She concentrates primarily in estate planning, estate administration, estate litigation and elder law. She has delivered CLE approved lectures. Her articles have been published in the New York Law Journal; the Richmond County Bar Association Journal; the New York State Bar Association Trusts and Estates Newsletter; the the CPA Journal.