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Q: What is a bypass trust and how does it work?

A: In the world of Trusts & Estates, there is a litany of Trust types all in variance according to the needs of either the Grantor (the Creator of the Trust) or the beneficiary (the person or entity who benefits from the Trust). Insurance Trusts, Special Needs Trusts, Spendthrift Trusts, & Trusts for Minors are only a few that seem to play a repetitious role in estate planning.

None however, are used more than the Bypass Trust. Also known as a Q-Tip Trust, the Bypass Trust is simple in nature, but provides long lasting benefits. The Bypass Trust deals with the issue of estate taxation; more specifically, the use of the estate tax exemption. As you may know, The Federal estate tax exemption has increased to \$5.45 million in 2016. This means that an estate valued at \$5.45 million or less suffers no estate taxes. Any amount over \$5.45 million is taxed at a rate of 45%! This exemption amount was said to be permanent, but there is always talk in Washington regarding changes in both the schedule and a reduction of the exclusion amount due to the economy.

For many years Connecticut matched the Federal exemption amount. But when the federal exemption increased from \$2 million to \$3.5 million back in 2008, Connecticut capped at \$2 million and remains at that level currently, which complicates the bypass process and changes the Trust value on a state level. (Other states vary as well.)

A Bypass Trust uses the art of Trust language to work the exemption to its greatest potential. Here's how it works. Normally, when a person dies, leaving a surviving spouse, everything in the dying spouse's estate is allowed to pass to the surviving spouse tax free. Nice, Huh? Here's the issue. When both spouses were alive, they each owned half of the estate. Now, the surviving spouse owns the entire estate, which is now double in size and has a greater chance of being exposed to taxation above the exemption allowance.

A bypass Trust, which can be either an Inter Vivos Trust (made and executed while living) or a Testamentary Trust (a trust created in the decedent's Will). The language of the Trust says instead of passing all of my estate to my spouse, put an amount equal to or less than the prevailing exemption amount in Trust for my spouse.



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Ok, everyone likes examples. Tarzan & Jane are married and have a \$10.9 million estate. Each is currently entitled to a \$5.45 million tax exemption. Tarzan passes away. Without the Trust Tarzan's estate passes to Jane tax free. Great, no tax (for now). But now Jane has a \$10.9 million estate. When she dies, she gets her \$5.45 million tax exemption, but... you guessed it; she now has another \$5.45 million over her exemption which is subject to Federal taxes at a rate of 45%. Basically, the federal government takes half. (And don't forget the state taxes!)

Same scenario, except, Tarzan has a Bypass Trust set up. Now when he dies, \$5.45 million of his estate goes into the Trust (for Jane's benefit) and the excess goes to Jane directly. A few months later Jane dies. Now, Jane's estate is only valued at the \$5.45 million rather than the \$10.9 million. So her estate now passes tax free as well because she is entitled to use her own \$5.45 million exemption. And the kids are even happier because they inherit more of the estate (either as residual Trust beneficiaries or estate beneficiaries) and give less to the government.

Do you need a bypass trust? I put one in most of my clients Wills. It's good to have regardless of the size of your estate because the amount of the exemption changes annually. The current federal exemption is high, but the state death tax exemptions are far lower, so the Bypass Trust will apply to most couples.

One caveat with all of this. The government is looking into Bypass Trusts and the current exemptions on a regular basis. If you intend to prepare such documents, seek legal counsel. In estate planning, the laws change often and legal counsel is necessary to ensure that such trusts are prepared and worded properly.

Anthony J. Medico, Esq., has practiced law for over 22 years. To ask a question for this column, or to receive Medico's free Estate Planning Survival Guide, visit his website at www.medicoandassociates.com, send an e-mail to Amedico@medicoandassociates.com or call (203) 661-8151. You can read most of his previous columns on his Greenwich Time estate planning blog on the internet. Just go to <http://www.greenwichtime.com/blogs> and scroll down until you find him under the business section. Enjoy.