



# When Bypass (Credit Shelter) Trusts Can Be A Disaster ©

By [Bob Parrish CPA](#)

725 Norton St  
Longboat Key FL 34228  
3205 Kermit Hwy Ste 2  
Odessa TX 79762

Telephone —  
FL 941/387-0926  
TX 432/367-3465

Fax —  
FL 941/387-0823  
TX 432/367-3465

Email: [bobparrish@pro1040.com](mailto:bobparrish@pro1040.com)  
On the Web: [www.pro1040.com](http://www.pro1040.com)

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## **INTRODUCTION**

This commentary is to be use only for educational purposes. This commentary does not include the writing of any legal document. The information contained herein is for the benefit of professionals with appropriate professional licensing in the appropriate jurisdiction. The information contained herein must not be used for a person not informed about such matters to draft any legal documents, nor modify documents, without consulting with an adviser.

## **STATEMENT OF NORMAL OBJECTIVES**

Usually the legal counsel will draft the will and/or the trust instrument. The legal counsel and the client must be willing to allow the CPA and the CFP to overview all legal documents before execution of those documents. The viewpoint of all planners is essential. This article uses a real-life example to —

- Communicate where the by-pass trust is not appropriate and can actually harm a surviving spouse or thwart the objectives of the decedent, and
- Discuss language and design problems in a by-pass trust

## **OBJECTIVE OF THE BYPASS TRUST**

To use the available estate tax credit to pass, transfer tax free, assets to the next generation (or other beneficiary of choice for the decedent).

## **OBJECTIVES OF DECEDENTS IN GENERAL**

To reduce the overall transfer taxes by using the estate tax credit for both the first to die and the surviving spouse, and full use of the marital deduction. Given the current transfer tax credit, the combined use of the credits offer a total of \$3.00 million dollars that can be passed on without incurring the confiscatory transfer tax rates.

## **HOW THE USE OF THIS STRATEGY CAN BE WRONG**

There can be, perhaps, an infinite number of circumstances in which the decedent should not use the bypass trust. The CPA, CFP, and Attorney should carefully consider what life might bring for the family *before* advising the use of this trust. Moreover, the CPA should be engaged by the client to overview the will each year. The CPA is usually responsible for assisting with the tax preparation and will be knowledgeable about the current tax law. Therefore, the CPA should be the designated person to assist the other professionals to monitor the plan and overview the documents annually during the preparation of the tax returns.

In the analysis of the language and design of the bypass trust in the example will, major risks shall be uncovered. One is the inappropriate use of the bypass trust, another, the potential inclusion of the taxable income of the trust, whether the surviving spouse receives the income distributions or the income is held in the trust and last, the potential loss of the estate tax credit (which is the sole intention of the bypass trust a.k.a. credit shelter trust).

## **WHERE IT CAN CREATE HARDSHIP OR IS NOT WARRANTED**

First shall be coverage of a few circumstances in which the bypass trust is not warranted and has the potential to harm the surviving spouse —

1. Place severe financial hardship on the surviving spouse – the size of the estate does not warrant the by-pass trust
2. Relatively young couples
3. Surviving spouse needs might not be met
4. Failure to meet decedent's objectives
5. Special needs

#### WHEN THE SIZE OF THE ESTATE DOES NOT WARRANT THE USE

If the estate will not incur the estate tax, nor the surviving spouse incur the estate tax, without the use of the bypass trust, the trust should not be used.

Furthermore, one must consider the tax reduction actually realized by projecting the estate tax brackets. The tax reduction benefit might not offset the additional costs for preparation, administration, compliance, and restrictions on use by the surviving spouse to warrant the use of the bypass trust.

If no transfer tax is due, the trust is unnecessary and should not be used. If only a small amount of transfer tax is due, the trust may wreak more financial havoc on the surviving spouse, or become more of a compliance and administrative burden than benefits received. This adviser has observed financial hardship placed upon a surviving spouse because of such a trust.

#### WHEN THE COUPLE IS YOUNG

For a young couple the trust normally would not be the first choice for planning. The older the couple is, the more probability the bypass trust will be a consideration (one must consider all the facts, circumstances, and other comments in this article).

Normally, the estate is not as large for a young couple than an older couple. Many times, the younger the couple the more probability there will be children, or young adults, the surviving parent will be wanting to, or needing to, care for.

There will be instances that warrant the use of the trust for a relatively young couple (less than 60). There will be other factors one must consider. Only a few are mentioned in this article, so the planner must carefully consider all the facts and circumstances now *and in the future*.

One instance is, whenever the size of the estate will increase in the future. If one spouse is to receive a large increase in the estate, from a distribution, inheritance, potential sale of property, or whatever source might be in the future for the couple, the surviving spouse may not need the money at the date of demise. In the cases where the surviving spouse is already provided for, the use of the bypass trust may not create a hardship on the surviving spouse and the use of the trust would be warranted.

#### WHEN THE SURVIVING SPOUSE NEEDS MIGHT NOT BE MET

Regardless of the potential transfer tax reduction, the welfare of the surviving spouse might dictate a “pay the tax and keep the remainder” philosophy.

Those circumstances in which the surviving spouse must be allowed to use the assets and income of the estate without restriction would be indicators the bypass trust should not be used. All advisers should exercise prudence in providing for the surviving spouse and his or her powers in the by-pass trust. A careful drafting of the trust can assist to some extent for providing sufficient income to the surviving spouse. However, if —

1. the language of the trust instrument is overly aggressive to provide for and vest control with the surviving spouse, or
2. there is lack of adverse parties, or
3. the trustee and the beneficiary are same person,

are set in the design, all can place the trust in a weak position for retaining the bypass trust provisions. More will be discussed later in this article regarding potential loss of the “credit shelter” provision.

### **THE OBJECTIVES OF THE DECEDENT MIGHT BE THWARTED**

If the decedent intends the bulk of the estate to go to the surviving spouse, and provide for the life style of the surviving spouse to continue, the bypass trust should not be used without careful consideration. The use of the bypass trust in some circumstances will thwart the intentions of the decedent.

For example, the size of Jerry’s estimated estate was \$1.5 million and the expected growth to Jerry’s expected date of demise would make the estate \$3.0 million. Jerry loved his wife and children dearly and was devoted to their happiness and welfare. Jerry did not like taxes — taxes of any kind. Jerry and his adviser decided to use the bypass trust as he could preserve the tax credit at his passing on by using the full \$1.5 million, the remaining \$1.5 million to go to his surviving spouse using the marital deduction. She would have an adequate amount to care for her, and there could be some distributions for her and the children from the bypass trust. Jerry’s estate encountered growth pains and did not grow at the expected rate. However, it had grown to about \$1.75 million when Jerry was involved in an accident that cost him his life. The trust instrument was not changed (this adviser is not convinced the use of Testamentary Trusts is in the best interest of the client). The estate and probate inventories were prepared, and the appraisals of the property requiring appraisal, were completed. The total was not \$1.75 but \$1.5 million.

THE ENTIRE ESTATE OF JERRY DID NOT GO TO HIS SURVIVING SPOUSE — NONE OF THE ESTATE WENT TO JERRY’S SURVIVING SPOUSE. THE ENTIRE ESTATE WAS FUNDED IN THE BYPASS TRUST.

This was not the intention Jerry had. Neither did the surviving spouse. The surviving spouse must confront and endure both, the most traumatic event in life one has to face, and she must also face financial hardship.

### **WHEN THERE ARE SPECIAL NEEDS**

There are instances where the surviving spouse or the children have special care needs. For those cases, one must consider a separate trust that will be used to fund the special needs of those requiring the care. One must consider the transfer tax amount, the amount of the needs, the potential tax reduction from the use of the trust, the objectives of the trustor, and the emotions of the trustor and the beneficiaries.

### **INCLUDE SAFEGUARDS**

This article makes the assumption the surviving spouse is to be included in the beneficiaries and the objective is to provide the bulk of, or enough assets/income to support the surviving spouse.

Although the bypass trust may offer many hazards, there are a few ideas that might serve to diminish a few of the hazards.

Identifying groups of assets to pass to the surviving spouse can be written into the instrument. Although there are disadvantages to identifying specific assets, the use of appropriate descriptions might accomplish the objective and help to ensure the surviving spouse takes title and control of the items instead of passing to the trust. A very common example is to pass the primary personal residence, household goods, and vehicles directory to the spouse by referring to those groups. Other examples of groups could be all real property, all residential property, all commercial property, etc.

However, other groups should be considered to be named to pass directly to the surviving spouse. Normally, retirement plans name someone other than the estate as beneficiary. If the estate is named as beneficiary, then in all probability the will should name the surviving spouse as the recipient of those assets (in which the deceased was a participant). If in a community property state, the community interest “owned by” the deceased in the spouse’s plans should be designated to flow through to the surviving spouse.

Another strategy is to use language that will limit the funding of the bypass trust. If after considering the size of the estate and needs of the surviving spouse there remains enough to fund the trust with the maximum credit, then fund the trust with the maximum amount to utilize the full credit. Otherwise, the funding would first go to the surviving spouse and the *remainder* goes to the bypass trust. NOTE: Take into consideration, ownership types, assets passing by beneficiary designation, transfer on death or contract, community property, prenuptial, antenuptial, and partition agreements.

### EXAMINE A REAL WORLD EXAMPLE – TRUST LANGUAGE & DESIGN PROBLEMS

1. Possible loss of the estate tax credit on the decedent’s estate and ultimate inclusion in the surviving spouses taxable estate
2. Possible pass-through of all bypass trust income whether distributed or not, to the surviving spouse

### EXCERPT FROM THE WILL

First, read the excerpts from the will establishing the bypass trust.

The Trustee is Jerry’s wife (surviving spouse) and she is also a beneficiary. Her powers as trustee and rights as beneficiary are discussed below. (Those granted powers might be a potential hazard to the tax treatments of the trust.) Jerry’s two children are also beneficiaries of the trust. However, neither child is given a definite right to receive distributions, nor any power to force distributions of either income or principal. Moreover, one of the beneficiaries is a minor living with the surviving spouse, and the other is attending college. The beneficiary attending college continues to live with the surviving spouse in her home when not in college. (The lack of power of the children beneficiaries, and the reality of them living with the trustee/beneficiary, risk them becoming considered subservient parties, involving another risk to the tax treatment of the trust.)

Quotation from the trust language in the will:

... If my wife survives me by thirty days, I give, devise and bequeath unto Mrs. Jerry as trustee, or should she fail or refuse to serve unto First Bank, my home town, as Trustee and her successors, and her substitute trustee or trustees, an amount equal to the amount, needed to increase my taxable estate to the largest

amount that will result in no federal estate tax being payable by my estate after allowing for the unified credit against the federal estate tax but no other credit, IN TRUST HOWEVER, for the following uses and purposes and subject to the following provisions, conditions and limitations

- (1) Discretionary payment of income. The trustee shall at any time pay to or apply for the benefit of Mrs. Jerry so much of the net income of the trust as the trustee in her sole discretion deems appropriate after considering to the extent known to her any other income or resources or earning power available to her. The trustee shall accumulate and add to principal at the end of the year any net income not distributed to her.
- (2) Invasion of Principal by Beneficiary. The trustee, in addition to any of the payments specified in this Will, shall pay to my wife on her written request such amount of the principal of the trust estate which the trustee determines to be reasonably required for her health, education, maintenance and support.
- (3) Termination. Upon the death of my wife, or upon my death in the event she, should predecease me, this Trust (subject to the postponements hereinafter specified) shall terminate and all of the assets and property comprising the principal of the same shall be delivered and distributed in fee simple and free of trust unto my children and the descendants of any deceased child if mine, per stirpes and not per capita, so that such descendants collectively shall take such share only as their parent would have taken if living.

The will continues with requirements that each child shall receive 1/3 at 22, 1/3 at 25 and the remainder at 28.

### [DISCUSSION OF THE PROBABLE RISKS](#)

In the case of Jerry, the bypass trust was not the proper use of the bypass trust. Since Jerry's spouse was left with nothing outside the trust, the bypass trust should not have been used. They were a relatively young couple with dependents requiring care in addition to the surviving spouse. Also, the size of the estate was not monitored in relation to the planning strategy used by Jerry.

The language of the testamentary bypass trust is of great concern. Furthermore, the language of the document fails to recognize §678.

The risks in the design of the trust are focused on the following topics:

1. Who is owner of trust assets – look to [General Power of Appointment](#) for guidance
2. [Dominion and Control](#)
3. [Adverse Parties](#)
4. [Ascertainable Standard](#)

### [GENERAL POWER OF APPOINTMENT — WHO IS OWNER?](#)

A general power of appointment is a right to use or appropriate property subject to that power. (In the normal and strict context of the discussion of §2041 the concern is whether to include the values in

the gross estate. That is not the issue herein. Herein the intent is to add discussion about §2041 and the related regulations as a test of ownership by a non-grantor individual. This is a test applied to the surviving spouse as the trustee/beneficiary. This shall be covered in more detail and perhaps find more relevance in the [Ascertainable Standard](#) discussion along with §678.)

The Tax Code offers the guidance for the language of a trust to be excluded from the estate of the decedent, and avoid a “General Power of Appointment” classification<sup>1</sup>. The language in the testamentary trust portion mimics the language in the Code and thereby may avoid the power of appointment treatment for the surviving spouse. “Health, education, maintenance, and support” is intended to meet the ascertainable standard required by the code.<sup>2</sup> *However*, one must look to §678 discussed later in this article which makes the ascertainable standard<sup>1</sup> a useless argument.

The assets belonged to Jerry and are includible in Jerry’s gross estate. Within the context of Jerry’s estate, there is no obvious concern for the estate tax, as the bypass trust has nothing to do with Jerry’s powers (and as stated previously, because of Jerry’s ownership the assets are includible in his estate). Jerry’s powers are non-existent as trustee of the by-pass trust (the trust was created in Jerry’s will and obviously Jerry is not and was not the trustee). The discussion is not concerned with inclusion of the trust assets in Jerry’s estate — there is concern about the surviving spouse’s ownership for purposes of the transfer falling under the marital deduction, or as intended to pass to the other beneficiaries and fall under the estate tax credit provisions.

Because of the marital deduction, there is no risk of additional estate tax for Jerry’s estate. One of the concerns is that the credit on the estate of the first to die will be lost. The intention was to maximize the use of the credit — in some estates this will be an important tax reduction feature to protect. In Jerry’s estate, there is no concern because there is no foreseeable estate tax for the family. However, that does not make the drafting correct. The intention is to discuss the risks in the actual language of the Will — with some families the retention of the credit will be important and the credit will be intended to be used.

Depending upon the definition of “... health, education, maintenance, and support” the risk to the trust does not *appear* to be very great from the viewpoint of the Power of Appointment standard. Keep in mind the test to run, is on the surviving spouse as a potential owner of all the trust assets. However, if maintenance and support (a portion of the ascertainable standard to limit the use by the surviving spouse) exclude some of the intended use of the distributions, there can be risks involved.

The use of the “ascertainable” standard frequently arises where a trust is created in which the beneficiary is the sole trustee and may make distributions for his or her support. Such a trust will avoid the Federal estate tax under IRC §2041, but will still be a grantor trust under IRC §678. Keep in mind this test is normally used when the trustor is the decedent. It can be used for any person that might have a power of appointment. Moreover, as this discussion continues the entire trust arrangement shall be in focus so the reader may understand where the reaching of the ascertainable standard is so contingent, the inclusion in the estate of the surviving spouse might become a necessity (and in some cases very costly).

However, in the above referenced language one must look at other risks. The following will select risks and address each one.

### DOMINION AND CONTROL

Although a By-pass Trust may satisfy the language in §20.2041-1 to meet the “ascertainable standard” test and thereby avoid the classification of a “General Power of Appointment” a Will

inadvertently can be drafted to potentially make the Trust ignored for both income tax and estate tax purposes (“*Unintentionally Defective Trust*”). If —

1. total control and benefit is placed with the spouse,
2. only subservient beneficiaries are included,
3. along with the spouse’s life estate and authority to invade corpus
4. being limited only by the inclusion of the mimicked language
5. without including controls (i.e. unrestricted withdrawal rights and including only subservient beneficiaries) to enforce the ascertainable standard,

serious faults have been written into the design and language to potentially allow the IRS denial of the use of the estate tax credit for the first to die and ultimately demanding inclusion of the value (intended to be in the by-pass trust) in the estate of the surviving spouse.<sup>8</sup>

The language of the trust might conflict with other provisions in the Trust arena allowing the IRS to challenge the Trust Instrument as ineffective. This has the potential risk to force all The Trust assets under the full dominion and control of the surviving spouse, the danger existing is that the trust assets might be considered owned by the surviving spouse, pass directly to the spouse as defined in the Tax Code and cause the loss of the benefits of the estate tax credit (use of the credit was the intention of the will). The authority granted the surviving spouse has created a contingency so the decedent’s transfer using the trust has not met the “present interest” requirement — it has become a future (which value cannot be ascertained) interest. Since the children potentially lack a present interest in the property a potential problem has been created. The following will take an excerpt of an actual Will and explain the dangers aforementioned.

### **Discretionary Payment of Income — Owner of Income**

First, examine the language within the trust instrument:

- (1) Discretionary Payment of Income. The trustee shall at any time pay to or apply for the benefit of Jerry’s Spouse so much of the net income of the trust as the trustee in her sole discretion deems appropriate after considering to the extent known to her any other income or resources or earning power available to her. The trustee shall accumulate and add to principal at the end of the year any net income not distributed to her.

The trustee and the beneficiary are the same person. She (the surviving spouse) has full dominion and control of the trust income and benefits from the distribution and her unimpeded decisions.

Although there is a requirement to consider the income from other sources, there is no language indicating any standard, budget, or restriction on the amount of the money required for the life style being maintained. There are no requirements to limit the income paid by the spouse to herself. Moreover, there is no provision to distribute income to the children (the point of the credit shelter) written into the trust instrument. There is no “ascertainable standard” to restrict or limit the use of the income by the surviving spouse (who is both the trustee and the beneficiary). Absent any standards regarding the income of the trust, the beneficiaries have no recourse either through the trust instrument itself, or through the courts, to restrict the trustee/beneficiary, or provide for any access to the income for the other beneficiaries.) If there are doubts, or contingencies the non-spouse beneficiaries will ever receive the income, or ever receive the trust corpus there is a risk of challenge to the tax benefits of the credit shelter.

The trustee/beneficiary possesses sole authority to receive the beneficial enjoyment of the corpus **or** the income, and there is very strong and convincing reasoning the only other beneficiaries are subservient to the trustee/beneficiary.

Within §678 there is no exception for the ascertainable standard. Some recent court decisions have written in the ascertainable standard exception for the trust when the same person is both beneficiary and trustee. However, the trust language omitted the ascertainable standard for the income of the trust. Please recall there are no adverse parties and the income might be used to discharge the support obligations of the trustee-beneficiary.

Before leaving this discussion, we consider a Revenue Ruling regarding the treatment of the trust income. The full text is listed in the endnotes and therefore is not included in full herein. The Ruling is the surviving spouse must include the income in her personal taxable income, similar to the Grantor Trust rules.<sup>3</sup>

The potential tax position is that the income belongs to the surviving spouse.

### **Invasion of Principal by Beneficiary — Owner of Corpus**

- (2) Invasion of Principal by Beneficiary. The trustee, in addition any of the payments specified in this will, shall pay to my wife on her written request such amount of the principal of the trust estate which the trustee determines to be reasonably required for her health, education, maintenance and support.

Can a Trust be attacked as ineffective (Defective) and the property transferred to the Trust considered to be owned by the surviving spouse?

Sometimes, one will look at seemingly unrelated Code sections to assist with the potential IRS Tax position or potential for challenges the taxpayer wants to avoid. (For example, herein research will include the Grantor Trust provisions from §671-§678 to read about “ownership”) Reading the powers vested in the surviving spouse should make the adviser concerned about,

1. the challenge to the income tax treatment,
2. the availability of the credit shelter,
3. a challenge the surviving spouse is owner of both the income *and* the corpus,
4. in general, loss of the intent of the deceased for all tax purposes (income and use of the estate tax credit.

On the “bright side of the drafting problems”, loss of all tax purposes will affirm total use and control by the surviving spouse and perhaps, given the right arguments, allow the surviving spouse to use the trust income and assets without concern for the other beneficiaries. The Code section considered, is the portion of the Code relating to “Grantor Trusts”.<sup>4</sup>

In §674 the adviser finds some assistance in looking for a potential problem with the given arrangement.

Power to control beneficial enjoyment

Current through P.L. 108-134 approved 11-22-03

- (a) General rule.--The grantor shall be treated as the owner of any portion of a trust in respect of which the beneficial enjoyment of the corpus or the income therefrom is subject to a power of disposition, exercisable by the grantor or a nonadverse party, or both, without the approval or consent of any adverse party.

Although, this Section is concerned with Grantor Type trusts and the tax treatment of the Grantor the adviser can find a potential problem with any trust that does not use an independent trustee and does not have adverse parties as beneficiaries.

The surviving spouse is both the trustee with the powers and the beneficiary to receive the benefits of the distribution.

Although there are other beneficiaries, advisers must consider whether the beneficiaries are or will be considered adverse parties. Both parties have a very close relationship to the surviving spouse beneficiary — mother-son relationships. One party is a minor and lives in the same household as the surviving spouse/beneficiary. The only other party has not graduated from college and spends away from school time with the mother. There is a high probability the mother will use distributions that will care for the group. There is a high probability the only two beneficiaries other than the trustee/beneficiary will never make any complaints about the use of the trust income or the trust corpus. The other two beneficiaries have nothing to gain by making any objections. Furthermore, as the children and the mother-trustee-beneficiary age, there is probability the children at some time will be responsible to care for the mother-trustee-beneficiary. At that time, there will be little incentive to withdraw funds, even if they could find some adverse party authority. The withdrawal of funds would deplete the Trust assets and require the other two beneficiaries to use personal funds to care for the mother.

#### **PERHAPS NO SERIOUS PROBLEM**

One must look at §674, and other authoritative sources for the guidance. A common thread in these is the “ascertainable standard” or limitation on the authority of the distributions. The language in the trust mimics the ascertainable standard for a power of appointment. This is found in §20.2041-1(c)(3) and again in §674.

If the inclusion of income in the surviving spouse’s taxable income is not an issue, then drafting of this section can be more lax. If it is an issue or might be an issue, then the drafting must be more precise.

If the asset protection is not an issue, the spendthrift clause in the will, the drafting language and the design of the trust can be more lax. However, the inclusion of the spendthrift provision would appear to make the adviser believe this was or might be an important issue. If it does become important in the future due to unforeseen incidences, then the language given herein might fall short of the intentions of the deceased. (The use of better language and alternate trustees with alternate trustee powers is too far from the given topic of this article and is covered in a separate article by this adviser.)

#### **HOWEVER THERE ARE PREVENTABLE CHALLENGES**

The adviser has discovered there is lack of any adverse party in the construction of the trust.

#### **Adverse Parties (Subservient Parties)**

One of the common threads for validating a trust (Removing the argument the principal does not belong to a person other than the trust) is for the trust to have adverse parties as beneficiaries. Failing to meet the adverse party criteria might weaken the argument that the trust principal or corpus was transferred to the children by trust. If the trust corpus is found to belong to the surviving spouse the marital deduction can be used, but the use of the credit for the first to pass-on is lost.

The children may not qualify as adverse parties. The relationship is sufficiently close to make the children subservient to the trustee/beneficiary. The children can be said to benefit from the distributions to the trustee/beneficiary. However, this may not be sufficient to make the property actually a completed transfer to or for the benefit of the children. On the other hand, if the trustee (who is the surviving spouse and mother of the other parties in the trust) uses the distributions to fulfill her support obligations of dependents (the children who other parties in the trust) the trustee is considered to own the trust property (Upjohn v United States).<sup>5</sup>

### **Ascertainable Standard**

As mentioned previously §20.2041-1(c)(3) and again in §674 provide the avoidance of a General Power of Appointment by using the guidance in those sections.

A general power of appointment is a right to use or appropriate property subject to that power. The power is conveyed by will or trust from one person (the donor, testator, or trustor) to another (the donee or holder). The holder of the power receives all rights to appoint the property to him- or herself or others in accordance with the terms of the will or trust instrument. If the power is exercisable in favor of the holder, it is a general power of appointment, and the value of all property subject to that power will be included in the gross estate of the holder at the date of death.

By definition, a general power of appointment is a power over the disposition of property which is "exercisable in favor of the decedent, his estate, his creditors, or the creditors of his estate" IRC Sec. 2041(b)(1), with certain exceptions. Exercise or release (other than by disclaimer) of a general power of appointment is a transfer subject to gift tax under IRC Sec. 2514. A general power of appointment created on or before October 21, 1942, which has either been released or not exercised will not be includible in the value of the gross estate of the holder IRC Sec. 2041(a)(1).

### **Treatment of Trust Income**

If one inspects the power to distribute income, the adviser finds:

“ ... so much of the net income of the trust as the trustee in her sole discretion ...”

This language does not meet the ascertainable standard test and offers sole dominion and control over the income of the bypass trust.

### **Treatment of Trust Principal**

The adviser observes the language mimics §2041 and §20.2041. However, simply including that language may not suffice if there are other indicators the surviving spouse has more control. The surviving spouse has a life estate in the trust property. The surviving spouse has the power to use the principal subject limited only to using it for her health, education, maintenance, and support.

Moreover, the only two beneficiaries that would limit the use to the health, education, maintenance, and support, are so closely related to the surviving spouse they become subservient to the surviving spouse and are not adverse parties. Furthermore, the other two beneficiaries would have a responsibility to care for the surviving spouse and therefore creates more evidence the other two beneficiaries will never receive the assets of the bypass trust and increases the risk of the loss of the credit for the first to die. Reiterating — the trust principal is in reality owned by and controlled by the surviving spouse, not that of the children.

Although the surviving spouse is holding a Life Estate in the trust property – she has the power to withdraw the trust corpus for her own use.

### **Owner Other Than Grantor**

#### **HOWEVER MORE RISKS LURK—**

Failure to consider §678 may offer a sad surprise for those associated with the bypass trust. §678 hides more risks not evidenced in the setup and language of the bypass trust.

Section 678 provides that a person other than the grantor is to be treated as the owner of any portion of a trust (and therefore taxable on the trust income as to that portion) as to which she has a power exercisable solely by herself to vest corpus or income in herself.

Code Section 678 provides rules for treating beneficiaries as the owners of trusts where the grantor trust rules of Code Sections 673, 674, 675, 676, 677 and 679 do not apply. An individual is treated as the owner of any portion of a trust as to which she has the sole power to distribute principal or income to herself.

There are no Crummey provisions included in the language, or any similar type provision allowing the children of the deceased a window of opportunity to withdraw trust funds. Furthermore, the income appears to be reserved for the surviving spouse and the surviving spouse's life estate in the Corpus appears to restrict any use by the children (the only other beneficiaries).

#### **Nongrantor Has Sole Power**

It should be noted that the power held by the Nongrantor will be deemed a taxable power only if it is solely exercisable by her. Whether the power is held in a fiduciary or nonfiduciary capacity, or whether it is subject to an ascertainable standard, is immaterial<sup>6</sup> under the general rule of Section 678(a)(1). Apparently, if the power is bona fide exercisable by the trustee/beneficiary solely in her power, the mere possession of the power will result in taxability.

#### **Surviving Spouse Might NOT Be Owner Under §678**

A life tenant under these testamentary provisions may not in any manner control the disposition of the corpus except by consuming it for the enumerated purposes.<sup>7</sup> She may not give it away nor make testamentary disposition of it. She has no power of appointment. She may not change the beneficiaries nor apportion their shares.

#### **Obligations of Support**

Where the non-grantor has a power, either as trustee or co-trustee, to apply the trust income for her own benefit by the discharge of her legal obligations of support, the mere existence of the power will not result in taxability of the trust income to her. She will be taxable on the trust income only to the extent that it is actually applied for the support or maintenance of her legal dependents. This exception is similar to that found in cases where the grantor has a power to apply income to the support of her dependents.

#### **Other Comments**

Simply possessing the power to accumulate income, might work either direction — making the transfer to the children (as subservient parties) incomplete<sup>8</sup>, or perhaps it can be argued this strengthens the position of the remaindermen.

SUMMARY

Although the bypass trust is a very useful tool, do not use this strategy without careful consideration. There are circumstances that do not warrant the use of the by-pass trust. There are circumstances in which the use will create undue burdens without significant benefits, create financial hardships on the surviving spouse, or perhaps if drafted incorrectly or overly aggressive language to make distributions to the surviving spouse (upon her will and control) can produce unexpected and perhaps disastrous tax or financial results.

All advisers must be aware of and gain knowledge about the following circumstances:

1. Size of the estate — savings may not be significant
2. Couple is relatively young
3. Surviving spouse needs may not be met — size of estate is one factor and size of needs of the surviving spouse in relation to size of estate
4. Objectives of the decedent might be thwarted
5. When there are special needs

Some attorneys will make the trust a testamentary trust. This adviser's personal opinion is to refrain from or restrict the use of testamentary trusts. The testamentary trust must be funded under the probate court procedures, which removes some of the privacy most individuals prefer. Moreover, the testamentary trust will be under the probate procedures making the assets subject to contests and creditors. The testamentary trust will also incur additional legal fees because of the process through probate.

Read the trust language. This is a necessity for the CPA and the CFP. The CPA will overview the document from the viewpoint of the tax code and the accounting issues. The CFP will view the document from the viewpoint of the planner. If the legal counsel does not cooperate, use your skills to convince both the client and the legal counsel of the necessity to read the document, since your advice is being used in some part of the process. If you have read the tax code, you may have suggestions for revisions, or desire to make your client aware of potential problems with the trust language.

Very truly yours,

B o b P a r r i s h C P A , P . C .

by

*Bob Parrish CPA*

Bob Parrish CPA Engagement Manager

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<sup>1</sup> §20.2041-1(c)(3)

<sup>2</sup> §20.2041-1(c)(3) and cross reference to §2041(b)(1)(A)

<sup>3</sup> Code Secs. 678, 661, 662

26 CFR 1.678(a)-1: Person other than grantor treated as substantial owner; general rule. (Also Sections 661, 662; 1.661(a)-2, 1.662(a)-3.)

A widow, having under the will of her deceased husband a power exercisable solely by herself to vest in herself certain amounts annually from corpus of the residuary trust, is treated under section 678(a) of the Internal Revenue Code of 1954 as the owner of that portion of the trust corpus which she may vest in herself in the taxable year. The widow's right to exercise such power was not cumulative, so that upon her failure to exercise it before the end of any calendar year, her right as to that year lapsed. As owner of a portion of the trust corpus, there are included under section 671 of the Code in computing her tax liability those items of income, deduction, and credit against tax attributable to or included in that portion. The portions of trust corpus considered owned by the widow are not subject to the provisions of sections 661(a)(2) and 662(a)(2) of the Code when distributed to her.

#### REV. RUL. 67-241

A decedent in his will gave his widow a power, exercisable solely by her, to require the trustees of the residuary trust created under his will to pay to her at her request from corpus during any calendar year an amount equal to the greater of five percent of the value of the trust corpus or \$5,000. The widow's right to exercise such power was not cumulative, so that upon her failure to exercise it before the end of any calendar year, her right as to that year lapsed. The trust income was payable in equal amounts to the decedent's two sons.

Section 678(a)(1) of the Internal Revenue Code of 1954 provides a general rule that a person other than the grantor shall be treated as the owner of any portion of a trust with respect to which such person has a power exercisable solely by himself to vest the corpus or the income therefrom in himself.

Where a grantor or another person is treated under sections 673 through 678 of the Code as the owner of any portion of a trust, there are included under section 671 of the Code in computing his tax liability those items of income, deduction, and credit against tax, attributable to or included in that portion.

Section 1.671-2(d) of the Income Tax Regulations provides that items of income, deduction, and credit not attributable to or included in any portion of a trust of which the grantor or another person is treated as the owner under sections 671 through 687 of the Code are subject to the provisions of sections 641 through 668 of the Code.

Sections 661(a)(2) and 662(a)(2) of the Code treat all distributions (with certain exceptions) to beneficiaries, whether of income or principal, as deductible by the trust and taxable to the beneficiary, subject to the limitations determined by distributable net income of the trust.

Since the widow has a power exercisable solely by herself to vest a portion of the trust corpus in herself, she is treated as the owner of that portion of the trust under section 678 of the Code.

As the owner of a portion of the trust corpus, there are included in computing her tax liability those items of income, deduction, and credit against tax attributable to or included in that portion. Pursuant to the provisions of section 1.671-4 of the regulations, these items should not be reported by the trust on Form 1041, U.S. Fiduciary Income Tax Return (for estates, and trusts), but should be shown on a separate statement to be attached to that form.

The portions of trust corpus considered owned by the widow are not subject to the provisions of sections 661(a)(2) and 662(a)(2) of the Code when distributed to her.

<sup>4</sup> §671-679 and the related Regulations

<sup>5</sup> This case involves §2503(c) and is known as *Upjohn v United States* (Western District of Michigan 1972). The Sample Trust and Will language in this case do not contain an “Upjohn clause, which prohibits the trustee from making any distributions that would have the effect of discharging that trustee’s legal obligations.

<sup>6</sup> § 678. Person other than grantor treated as substantial owner

Current through P.L. 108-134 approved 11-22-03

(a) General rule.--A person other than the grantor shall be treated as the owner of any portion of a trust with respect to which:

(1) such person has a power exercisable solely by himself to vest the corpus or the income therefrom in himself, or

(2) such person has previously partially released or otherwise modified such a power and after the release or modification retains such control as would, within the principles of sections 671 to 677, inclusive, subject a grantor of a trust to treatment as the owner thereof.

(b) Exception where grantor is taxable.--Subsection (a) shall not apply with respect to a power over income, as originally granted or thereafter modified, if the grantor of the trust or a transferor (to whom section 679 applies) is otherwise treated as the owner under the provisions of this subpart other than this section.

(c) Obligations of support.--Subsection (a) shall not apply to a power which enables such person, in the capacity of trustee or co-trustee, merely to apply the income of the trust to the support or maintenance of a person whom the holder of the power is obligated to support or maintain except to the extent that such income is so applied. In cases where the amounts so applied or distributed are paid out of corpus or out of other than income of the taxable year, such amounts shall be considered to be an amount paid or credited within the meaning of paragraph (2) of section 661(a) and shall be taxed to the holder of the power under section 662.

(e) Cross reference.--

For provision under which beneficiary of trust is treated as owner of the portion of the trust which consists of stock in an S corporation, see section 1361(d).

<sup>7</sup> The language in the will which mimics §20.2041-1(c)(3)

<sup>8</sup> §25.2511-1(g)(2)

(2) If a trustee has a beneficial interest in trust property, a transfer of the property by the trustee is not a taxable transfer if it is made pursuant to a fiduciary power the exercise or nonexercise of which is limited by a reasonably fixed or ascertainable standard which is set forth in the trust instrument. A clearly measurable standard under which the holder of a power is legally accountable is such a standard for this purpose. For Taxpayer Advocate, Asset Protection Coach, Cost Containment Counselor, Investment & Acquisition/Merger Analyst; Management Consultant; Tax Preparer (Income, All States, Sales, Payroll, Estate), Accountant, Auditor, Financial & Estate Planner, Bankruptcy Reporting, Probate Reporting

instance, a power to distribute corpus for the education, support, maintenance, or health of the beneficiary; for his reasonable support and comfort; to enable him to maintain his accustomed standard of living; or to meet an emergency, would be such a standard. However, a power to distribute corpus for the pleasure, desire, or happiness of a beneficiary is not such a standard. **The entire context of a provision of a trust instrument granting a power must be considered in determining whether the power is limited by a reasonably definite standard.** For example, if a trust instrument provides that the determination of the trustee shall be conclusive with respect to the exercise or nonexercise of a power, the power is not limited by a reasonably definite standard. However, the fact that the governing instrument is phrased in discretionary terms is not in itself an indication that no such standard exists.