Bypass Trust. The Simplest and Easiest Way to Reduce or Eliminate Estate Taxes

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How many years will it take your kids to save $100,000 after taxes? For those readers who are married and have an estate of $2 million or more, a bypass trust can save the ones you love at least $100,000 in estate taxes. Do I have your attention yet?

A bypass trust is sometimes known as a family trust or a credit shelter trust. When the first spouse of a married couple dies, he or she can pass all his or her assets to the surviving spouse free of estate taxes because of the marital deduction. But when the surviving spouse later passes on, his or her estate will now be much larger because of the assets inherited at the death of the first spouse to die.

Example 1: Oregon has a $1 million estate tax exemption. If Harry and Sally, who are married, each have $1 million in assets and Harry dies and gives all his assets to Sally, she will die with an estate of $2 million. She will have a $1 million exemption, and thus $1 million in assets will be subject to Oregon’s estate tax at the rate of 10 percent. Thus, Sally’s estate will end up paying a $100,000 Oregon estate tax.

If a bypass trust is utilized, that $100,000 in estate taxes can be saved! In Washington, where the estate exemption is $2 million, even more can be saved.

Example 2: If Harry and Sally, who are married, each have $1 million in assets and Harry dies and gives his $1 million to Sally in a bypass trust, when Sally later dies, the $1 million in the bypass trust is not included in her estate. She is treated as owning only the $1 million in assets that she owns outright. There is no tax at Sally’s death because the $1 million that Sally owns outright is fully sheltered by Oregon’s $1 million estate tax exemption.

Maximum flexibility can be built into a bypass trust. Here are the types of flexible provisions that a bypass trust for Sally might include:

- Sally can be the trustee of the trust.
- All income of the trust can be distributed to Sally or just as much as she needs for her health, education, maintenance, and support.
- Trust principal can be distributed to Sally for her health, education, maintenance, and support.
- Sally as trustee can distribute trust income or principal to children and grandchildren for their health, education, maintenance, and support.
- Sally can be given the right to determine after Harry’s death who among her children and grandchildren will receive the assets in the bypass trust, and whether they are distributed to a child or grandchild outright or in trust.

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Planning for the Blended Family

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Estate planners are increasingly confronted with remarriage as part of the considerations of a proper estate plan. This is not solely attributable to dissolution of marriages, but is also because many are living longer and healthier lives and there is increased frequency of remarriage among our senior population.

The planning considerations for the blended family range from the desire to take care of children to taking care of the new spouse. To address these considerations, estate planning counsel requires complete information on the financial status of the parties to the second marriage and legal and contractual obligations to children and former spouses. Sources of this information may include a property settlement agreement or decree of dissolution, pre- or post-marriage agreement, and detailed financial statements. With this information, your estate planning counsel can assist you in crafting a Will or trust that meets both your obligations and your desires regarding your new family.

Trusts are a common planning tool. Our colleague Ron Shellan has set forth the advantages of using a bypass trust as a tax savings device in his article in this edition of the publication. That same bypass trust can be used to solve the planning issues of a blended family. Let’s take a look at Harry’s and Sally’s situations in Ron’s hypothetical. Assume that both have children by prior marriages and they need the combined income from the $1 million that each has accumulated to maintain their lifestyle. As part of their estate plan, they want to be sure that the surviving spouse is able to continue to live in the manner to which he or she has become accustomed, but also wish to leave as much of their estate as reasonably possible to their children.

By using the bypass trust that Ron has described, the trust can provide that the income be distributed to the surviving spouse, Sally for this discussion, at least quarterly. Additionally, the trustee can make distributions of principal from the trust as necessary for Sally’s health, education, maintenance, and support. (In Washington, we recommend the use of an independent trustee to make decisions for the distribution of principal.) Upon Sally’s death, the balance of the trust is distributed to Harry’s children under the terms he has set forth in the bypass trust. Remember, the bypass trust exists as a result of the provisions of Harry’s Will. Sally’s Will can have similar provisions, establishing a trust for Harry. Both Wills can also provide that the children of the second to die take their parent’s estate. The net result is that the taxes Ron describes are saved and the descendants of each parent receive a distribution of approximately $1 million.

Another method for providing for obligations arising out of a blended marriage is life insurance. Assume that Harry is relatively young, is in good health, and has support obligations for young children. The support obligations can be quantified by reviewing the terms of the property settlement agreement or decree of dissolution. A term insurance policy, crafted to parallel the support obligations, can be acquired for a modest monthly premium. Upon Harry’s death, the policy proceeds will meet his obligation, allowing Harry to plan his estate for Sally’s benefit without regard to the support obligation.

As you know, members of Miller Nash LLP practice in Washington and Oregon. These articles are distributed to our friends and clients in both states, so they are written in a general form to cover both states. While the federal law overarches both states, each state has its own estate tax provisions. It is therefore important that you consult with an estate planning lawyer who is conversant with the tax provisions of the state in which you reside.
We hope you and your co-owners have implemented a “buy-sell” or “shareholder” agreement. If you have, that’s great! As we’ve stated before, this document (or similar provisions embedded in a limited liability company operating agreement or in a partnership agreement) is one of the most important agreements to put into place when you are a co-owner, especially when you are one of several co-owners who are actively working in the business. In our experience, however, most owners put these agreements into place early in their business relationship and rarely revisit their terms on a regular basis. We urge you to review your agreement today, especially if you have not looked at it recently.

When creating these arrangements (especially during the early stages of building a business), owners and their advisors usually give quite a lot of thought or analysis to the possibility of an owner’s untimely death, but little thought to the likelihood of a lifetime transfer. Instead, they focus all their attention on dealing with the least likely event—an owner’s death. Yet in our experience, lifetime transfers occur much more frequently, and when they do, if they have not been properly anticipated, they can cause huge problems. Buy-sell agreements that may work well in the event of a shareholder’s death, but fail to distinguish those same provisions (such as a first right of refusal at a predetermined price if an owner wishes to transfer ownership) from the provisions that will govern in the case of a lifetime transfer, can, at a minimum, become an impetus for renegotiation at a very late date—and, even worse, can be a potential for nightmares if they go unnoticed.

Let’s look at two examples of how the owners’ exclusive focus on death crippled them when the thing they least expected happened:

**Harry and Tom’s Story**

H&T Custom Tack almost didn’t get out of the corral. Harry and Tom had talked about pooling their resources (Harry’s thriving tack business and Tom’s reputation as one of the best custom saddle makers in Texas) for years, when Tom’s twin brother had a heart attack at age 55. Tom realized that life was too short to keep talking about creating a partnership, and the two decided to merge their talents at last.

Along with all the other documents that Tom and Harry’s attorney insisted on was a buy-sell agreement that established the price and the terms of a sale or purchase. Embedded in its creation was the assumption that one of them (probably Tom, since he was eight years older than Harry) would die and that Harry would purchase Tom’s ownership using life insurance proceeds.

The good news was that Tom answered the wake-up call to improve his life and lifestyle. Not only did he create a successful company, but he also replaced his daily drive across town to grab a chicken-fried steak or cheeseburger with brisk walks to the new vegetarian salad joint. He joined his wife for long bike rides on weekends and boasted that he’d never felt better.

The “bad” news was that before either of them could ride off to join the Big Rodeo in the Sky, Harry began to think about retiring and selling out. A quick look at their buy-sell agreement told Harry that he had to sell his stock to Tom based on the price they had established when they assumed that there would be more than adequate funding because of the life insurance policy.

Harry and Tom’s problems were just beginning. Because the price established in their buy-sell agreement had little to do with the fair market value of the company when one of them wanted to sell out, the price that an outside buyer would be willing to pay was likely to be substantially higher or lower than the company’s current value under their agreement. This meant that one or the other partner would suffer.

**Steve’s Story**

At age 38, Steve suddenly had a stroke. As is the case with many other stroke victims, his recovery was incomplete. Physically, he was the picture of health (his golf game even improved!), but he totally lost his ability to speak and read. Doctors told Steve that he would never be able to return to work.

Steve’s firm had a buy-sell agreement, but it required only a buyout at death and created an option for the company to buy Steve’s stock if he were to try to sell it to a third party. Trying to find and sell closely held stock to a third party is a difficult proposition anytime; Steve’s disability made it impossible. Even if his fellow

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The ILIT Solution

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An ILIT can solve a number of issues in planning for larger estates—most significantly, it can operate to reduce estate taxes and to help provide your survivors with the liquidity necessary to meet tax obligations and other expenses.

What is it?

An ILIT is an irrevocable life insurance trust. The trust owns, and is the beneficiary of, policies of insurance on a person's life. Properly formed, proceeds of life insurance policies payable to an ILIT will not be subject to estate taxes when you die (life insurance proceeds are generally not subject to income taxes). The ILIT can use the insurance proceeds to purchase assets from, or loan money to, an estate or trust so that tax and expense obligations can be met. By contrast, if you have incidents of ownership in a policy of insurance on your life, the policy proceeds will be includible in your estate for tax purposes.

How does the ILIT acquire life insurance policies?

An ILIT can purchase life insurance policies, or you assign your existing policies to the ILIT. If you transfer existing policies to an ILIT, you will need to survive the transfer for three years before the policy proceeds are excluded from your taxable estate.

How does the ILIT pay policy premiums?

You can fund an ILIT with assets so that the ILIT can meet premium payment obligations. More often, the ILIT is funded through annual contributions to cover premiums.

Who are the beneficiaries of the ILIT?

You can name the ILIT beneficiaries when you establish the ILIT. A person's spouse and descendants are most often named as beneficiaries. The insurance proceeds (or assets purchased with the proceeds) can remain in trust for the beneficiaries or can be distributed outright.

Who should act as trustee?

You can name the ILIT trustee, who must be someone other than yourself. The usual ability and integrity considerations would apply to the choice of a trustee—particularly when significant amounts of money may be involved.

Will there be gift taxes when premiums are paid?

A gift results when you provide funds to an ILIT for the payment of policy premiums. The cash value of existing policies placed in an ILIT will also be treated as a gift. If the ILIT is properly structured, you can use your gift tax annual exclusion (presently $14,000 per donee—$28,000 for gifts made by a married couple) to exempt the premium payments from federal gift taxes. Note that Oregon and Washington do not levy a gift tax, and the $5,250,000 federal unified credit amount applies to gifts in excess of the annual exclusion as well as to estate taxes. To ensure that the gift tax annual exclusion is available, the trust beneficiaries will need to have a limited withdrawal right during a set period of time after the funds are paid into the trust.

Pros and cons of an ILIT

An ILIT provides an attractive means of avoiding estate taxes on life insurance proceeds, planning for management of the proceeds for the beneficiaries’ benefit, and providing assurance of liquidity for your estate. You have considerable flexibility in establishing the ILIT; once it is established, however, you cannot change the beneficiaries, the ownership of the policies, or any other aspect of the ILIT.
The Advantages of Using LLCs for Estate Planning

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When used strategically, limited liability companies (“LLCs”) can be a vital estate planning tool. As with most other areas of tax planning, however, the use of LLCs for estate planning purposes requires a nuanced analysis that balances the utility of any given approach along with its potential risks in order to determine what the best strategy will be to achieve each client’s unique goals. This article is the first in a series discussing several ways in which the use of LLCs can be advantageous, specifically when used for estate planning purposes.

Advantages of Using an LLC

An LLC offers a flexible form in comparison to many other business entities, which makes it an attractive choice for use as an estate planning instrument. The relative freedom of members, the protection from liability, and the option to elect to be taxed as a corporation, a partnership, or a “disregarded entity” all make LLCs a smart choice as business or investment vehicles.

For these reasons, LLCs are widely used in many contexts. When we consider the passing of assets from one generation to the next—the particular context of estate planning—several other advantages of using LLCs become apparent. Broadly, because management of an LLC is not based on ownership, one generation can transfer the assets held by an LLC to the next generation without giving up control. Additionally, LLCs can use transfer restrictions in order to protect assets against potential creditors of members, and children’s ex-spouses. Appreciation in the value of an LLC’s assets is not includible in the taxable estate of the transferor; only the value of any retained interest in an LLC will be taxed.

Beyond the broad advantages described above, specific arenas of investment benefit in different ways from the use of an LLC: If parents who own rental property want to pass that property to their children, the use of an LLC will allow them to divide the interest into equal shares and pass LLC membership interest to each child, thus accomplishing their goal without having to create separate fractional deeds for each transfer. For stock investors who want to distribute investments among children or other parties, holding the entirety of an investment in an LLC and distributing LLC membership interest, instead of splitting the investment assets into separate stock portfolios, allows each recipient to enjoy the benefits of greater diversification. For parents managing an active business, gifting LLC membership interest in that business can allow them to pass interest to their children gradually over time, without relinquishing management and control.

In addition to these advantages, in this article we will look at the particular role that valuation discounts can play, and what tax savings can be achieved, when transferring ownership of interest in an LLC. Future articles will cover other tax-planning use of LLCs, including the use of LLCs by owners of out-of-state real property in order to avoid ancillary probate, and a discussion of how the rules governing the annual exclusion from gift tax relate to gifting of LLC interests.

Valuation Discounts

Perhaps the strongest argument for use of an LLC as part of an estate plan is to take advantage of the transfer tax discounts that passing fractional shares of LLC interest can create. The two types of valuation discounts that the IRS most commonly applies in determining the value of a business entity for tax purposes are (i) a discount for “lack of control” or “minority,” and (ii) a discount for “lack of marketability.”

Conceptually, discounting LLC interests for these reasons makes sense: owning a minority share in an entity comes with significantly fewer rights, and as a consequence, the value of a minority share may be worth less, and will be less marketable to a potential buyer.

The Tax Court has recognized minority interest discounts of 25 percent or greater, resulting from an owner’s lack of control over management. Whether or not the minority interest holder has the ability to compel distributions and to force liquidation and receive a proportionate share of the entity’s net asset value are factors that are frequently taken into account in determining whether to apply a discount, and if so, how much. Without the ability to compel distributions or force liquidation, a potential buyer of such an interest will likely not want to pay a price that might be fair for the full value of the assets if they were held outright or even as a majority interest.

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A discount for lack of marketability can range from zero to 30 percent, and reflects the lack of a ready market for the LLC interest. Practically, this discount is often closely related to the minority interest discount. In order to take full advantage of the available discount here, an LLC’s operating agreement should contain restrictions on the right of members to convert their interests to cash, because such a restriction will decrease the value of each member’s LLC interest.

**Limitations**

Property transferred to an LLC will not receive a step-up in income tax basis, except to the extent of the discounted value of the transferor’s retained interest in the LLC at the time of the transferor’s death. Particularly now, with income tax rates plus the “Medicare Surtax” potentially combining to create a higher tax rate on income than would be paid in estate or gift tax, close attention should be paid to which assets would be best suited for an LLC in order to maximize overall tax savings.

Additionally, it should be noted that in order to receive the kind of valuation discounts discussed above, an appraisal of LLC assets will likely be required.

LLCs can be a very useful tool in estate planning, and use of this form has become widely popular for both practical and tax-savings reasons. Determining whether an LLC is the best instrument to achieve your particular goals requires some level of analysis, however. Future articles in this space will discuss other considerations relating to the use of LLCs for estate planning purposes.

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**Your Buy-Sell . . . | Continued from page 3**

shareholders had wanted to continue his salary, they did not have the resources to do so indefinitely.

As a result, the company and Steve were left in a classic dilemma—the company, or rather the remaining shareholders, wanted to purchase Steve’s stock so that its future appreciation in value, due now to their efforts alone, would be fully available to them. Conversely, as Steve’s family soon realized, the owners of closely held stock rarely receive current benefits in the form of dividends. The profits of a closely held corporation are either accumulated by the company or distributed to the active shareholders in the form of salaries, bonuses, and other perks.

In short, Steve’s family would not get what it needed most—cash—to replace the salary that Steve was no longer earning, and Steve’s partners faced the prospect that their efforts to increase the value of the business would reward Steve and his family as much as themselves.

There are additional problems that can result from a narrow-scope buy-sell agreement. If the owners have presumed that only death would separate them, then there may not have been any comprehensive planning to minimize the tax consequences of a lifetime sale. Further, if there is an assumption that the survivor will use life insurance proceeds (rather than company cash flow) to fund a buyout, the buyout terms described in the agreement may not create an adequate time frame to pay for a lifetime purchase if the purchase price will have to come from the company’s cash flow. Even when there is a repurchase using life insurance proceeds, there are tax basis and alternative minimum tax considerations that should be considered in the plan. Finally, if there are only two owners, a good buy-sell agreement should consider methods for resolving irreconcilable differences between the owners, if and when they might occur.

When co-owners are united in striving toward common business goals such as growing revenue, building business value, and increasing cash flow, the business dynamics can be wonderfully positive and strong. These owners easily work together to reach common goals. But even the most positive business success cannot protect the owners from the possibility of a future time when the goals of the owners will diverge. The best, and perhaps only, way to prevent a future impasse when that happens is to address, today, potential problems that might be caused by a buy-sell agreement drafted years ago for a transfer event (death) that is not the event most likely to occur.

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If Harry’s Will or living trust provides for a disclaimer, Sally can make a decision up to nine months following Harry’s death whether to establish a bypass trust and what assets will pass to the bypass trust. But if she does transfer assets to the bypass trust using a disclaimer, Sally cannot have power described in the preceding bullet point to determine who receives trust assets following her death.

But wait, there’s more (without paying separate shipping and handling charges)! For federal estate tax purposes, the exemption is now set at $5.25 million, and for a couple, under new federal portability law, the unused $5.25 million exemption on the death of the first spouse will pass to the surviving spouse. Thus, without using a bypass trust in a state such as California, which does not have an estate tax, a married couple can ultimately pass $10.5 million to their children or others.

For couples with larger estates that might exceed the federal estate tax exemption of $5.25 million, a bypass trust can still save substantial estate taxes. For example, there can be additional savings by using a bypass trust in certain remarriage situations and when the assets substantially appreciate:

Example 3: Harry has a taxable estate of $5.25 million, as does Sally. Harry dies and passes his estate to Sally outright. Sally remarries, and her new husband predeceases her. As a result, she loses the “portable” $5.25 million federal exemption from Harry. She would die with a taxable estate of $10.5 million, and $5.25 million would be subject to an estate tax at the 40 percent rate, for a total federal estate tax of $2.1 million. Ouch! If Harry had given his $5.25 million to Sally in a bypass trust, the tax on Sally’s death would be zero, for a savings of $2.1 million.

Example 4: Harry has a taxable estate of $5.25 million, as does Sally. Harry dies and passes his estate to Sally outright. Harry’s estate owns stock in a great high-tech company that appreciates after his death by $5 million. Sally dies with a total estate of $15.5 million and because of portability has a combined estate tax exemption of $10.5 million. But the $5 million in appreciation is taxed at a rate of 40 percent, creating an estate tax of $2 million.

If Harry had given his assets to Sally in a bypass trust, the entire value of the assets in the bypass trust, including the appreciation in those assets, would be excluded from Sally’s estate. Thus, when Sally died, the part of her estate subject to estate tax would be only $5.25 million (instead of $15.5 million), all of which would be sheltered from the federal estate tax by the estate tax exemption. The tax on Sally’s estate on her death would be zero, for a savings of $2 million.

The bypass trust is the most flexible and most often used tool in the estate planner’s arsenal. It has great flexibility. For couples in Oregon, the savings start at combined estates in excess of $1 million. For Washington couples, the savings start at combined estates in excess of $2 million. The savings can be substantial. So is it worth it to use a bypass trust to save $100,000 after tax for your children? Absolutely.
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