



The Bypass Trust: It's not Just for Taxes Anymore

By: Kevin Kinghorn



Ask any estate planning attorney about the purpose of a bypass trust, and you are certain to hear the familiar refrain, "It's to save taxes, dummy." With the ever-changing landscape of estate tax laws, and with the accompanying uncertainty, estate planners have had to re-evaluate whether the bypass trust serves a purpose for most clients. The same estate planning attorney that tells you the purpose of the bypass trust is to save taxes is not likely to tell you the bypass trust can also be used to protect the assets from creditors of the surviving spouse or prevent the trust assets from being spent down for Medicaid qualifying purposes. Until now.

Asset Protection

Let's face it. The threat of litigation is not diminishing, and clients are always looking for ways to protect their assets from potential creditors. With a little careful drafting, the bypass trust can protect trust assets from the surviving spouse's creditors, while still allowing the surviving spouse to have access to the trust assets. Typically, the bypass trust requires the distribution of all income to the surviving spouse. In addition, the surviving spouse may have access to the principal of the bypass trust, limited by an ascertainable standard where the surviving spouse is also the trustee. But what if all distributions of principal and income were limited by the trustee's discretion? In such a case, were a creditor to attempt to compel distributions from the bypass trust, the creditor steps into the shoes of the beneficiary. Because all distributions are subject to the exercise of the trustee's discretion, the beneficiary cannot compel any distributions. Thus, the creditor is not permitted to any distributions of income or principal.

This is particularly persuasive where the trustee is not also the beneficiary. But even in that case, a carefully constructed provision which allows the surviving spouse to resign as trustee at the first hint of trouble from a potential creditor, in favor of a trustee friendly to the surviving spouse, would likely give similar asset protection.

What about income taxes, which is the most often cited reason for compelling income distributions from the bypass trust? When there are no creditors on the horizon, the trustee can exercise its discretion and distribute all of the income to the surviving spouse, resulting in the income being taxed at the surviving spouse's individual rates. When a creditor does surface, distributions are withheld and income is taxed at the higher trust rates. But even taxation at the higher rates keeps more in the trust than if the creditor were to get access to all of the income.

Long-Term Care Protection

Creditor protection is one challenge. Protecting assets from being spent down for Medicaid long-term care eligibility is an entirely different challenge. Generally, federal law provides that the assets of a trust, created by the spouse of a Medicaid recipient, are not considered available resources for purposes of determining Medicaid eligibility, but only if such a trust is created through a probate process. Although not counted for determining Medicaid eligibility, the assets of such a trust could still be used to provide for the needs of the surviving spouse.

The bypass trust could very simply be made to be such a trust. Of course, special needs language prohibiting the use of trust assets to supplant Medicaid benefits must be included, but these provisions could be drafted in a way that allows all of the usual distributions if the surviving spouse does not need Medicaid benefits. If the spouse does need long-term benefits, the special needs trust becomes operative. To ensure the bypass trust is funded through a probate process, the trust should allow the trustee to kick assets out of the trust and into probate in cases where a probate proceeding is not otherwise necessary.

This strategy works well when, at the death of the first spouse, it is known that the surviving spouse will need long-term care benefits. But what if the surviving spouse

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is healthy when the first spouse passes and it is uncertain whether the surviving spouse will need long-term care? In that case, the bypass trust will typically not be funded through a probate process and the trust assets will be considered available resources for Medicaid eligibility. There, a sprinkling power in the trust which would permit the trustee to “flush” the trust would be helpful to preserve the trust assets. If, when the surviving spouse needs long-term care, the trustee were to distribute the trust assets to, say, one or more of the surviving spouse's children, as can be permitted by a discretionary power in the bypass trust, the trust assets cannot be considered an available resource for Medicaid eligibility. Quite simply, if there are no assets in the trust, no assets can be considered as being available to the surviving spouse. The distribution from the bypass trust does not create an ineligibility because, according to Medicaid regulations, the assets of the trust are not owned by the surviving spouse. The children, who are the recipients of the trust assets, could informally use the assets to supplement the needs of the surviving spouse, much the same way a special needs trust works.

Conclusion

Estate planning attorneys can no longer afford to ignore the non-tax benefits of creating a bypass trust upon the death of the first spouse. Properly drafted, a bypass trust can protect the trust assets from being invaded by creditors or to pay for long-term care costs for the surviving spouse.

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