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MontGuide

Using a Bypass Trust to Provide for Children from Prior Marriage

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Blended families can bring special challenges to estate planning. A bypass trust is one tool that can help you create a plan to effectively pass your property along to the people you want, the way you want.

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BILL AND KAREN ARE CURRENTLY OPERATING THE farm that Karen inherited from her father. The farm is held in Karen's name as sole owner. The farm's value is approximately $950,000. Karen and Bill own other non-farm assets as joint tenants with right of survivorship (including stocks, bonds and certificates of deposit). These assets are valued at $300,000.

Karen and Bill each have an adult child from a prior marriage. They want Karen's daughter to inherit the farm. They want Bill's son and Karen's daughter to share the other assets in the estate equally.

Bill and Karen currently do not have a written will or any other type of transfer plan in place. They recently attended an estate planning seminar sponsored by MSU Extension and learned that without a written will their property will not pass as they desire.

Karen dies first (no written will)

If Karen dies without a written will, the $300,000 of non-farm assets transfers directly to Bill because they are held in joint tenancy with right of survivorship between Karen and Bill. Karen's land assets, valued at $950,000, are divided under Montana's intestacy statues because she did not have a written will. Bill, as the surviving spouse, receives the first $100,000 in value of Karen's land and half of the remainder. The other half passes to Karen's daughter. The result is that Bill receives $525,000 in value of the property solely owned by Karen, ($950,000 - $100,000 = $850,000 ÷ 2 = $425,000 + $100,000 = $525,000) and Karen's daughter receives $425,000 in value of the farm assets. This means Karen's daughter and Bill will be operating the farm together with Bill being the majority owner (55 percent). Bill also receives the non-farm assets of $300,000 that were titled in joint tenancy with right of survivorship with Karen. His inheritance totals $825,000.

Assume that Bill dies several years later, also without a written will. Bill's son would receive all of his interests in the farm, including any increase in value, and the remaining non-land assets that also increased in value since the time of Karen's death. Karen's daughter and Bill's son become co-owners of the farm. What if Bill's son demands sale of the property? What if Karen's daughter can't afford to buy out Bill's son? What if Karen's daughter dies before Bill?

Bill dies first (no written will)

If Bill dies without a written will, the $300,000 of non-farm assets transfers directly to Karen because they are held in joint tenancy with right of survivorship between Karen and Bill. Because Karen has the land in her name only, Bill's death does not affect ownership in the property. Karen now owns all of the assets. Bill's son receives nothing.

Assume Karen dies a few years later, also without a written will. Karen's daughter inherits her entire estate. Again, Bill's son receives nothing.

Developing an Estate Plan

Neither of these potential outcomes are what Bill and Karen desire. They decided to discuss their situation with an attorney whose practice focuses on estate planning. Their goal is to establish an estate plan that will meet their needs better than Montana's contract law and intestacy statutes.

Bill and Karen share their concerns with an attorney who explains several options. The first plan uses wills, without trusts, to accomplish their goals. However, because of the plan's simplicity, it does not meet their goals in every circumstance. The second plan adds a bypass trust to their wills. It is a more complex plan than the first plan but it provides better protection for both Karen's daughter and Bill's son.

Option #1 (Estate plan using two wills)

The attorney informed Bill and Karen that written wills can address many of their concerns. For example, Karen's will could state that if Bill is living when she dies, the land assets that Karen has titled in sole ownership are to be inherited by her daughter. The remaining portion of her estate would pass directly to Bill because the non-farm assests are held in joint tenancy with the right of survivorship. If Bill is not living when Karen dies, then her will could direct that all of the land assets transfer to her daughter and that the other assets to be divided equally between her daughter and Bill's son.

Both Karen's and Bill's wills could direct that if they die in a common accident their stocks, bonds, and certificates of deposit are divided equally between Bill's son and Karen's daughter. But as long as Karen is alive, Bill's will cannot control the assets they hold in joint tenancy with right of survivorship, nor can Karen's will control those assets as long as Bill is alive.

Although this plan appears to meet Bill and Karen's initial goals, the attorney outlined several shortcomings. First, if Karen dies first, her daughter inherits the land assets. Since Karen's daughter then owns the farm, Bill may find himself in the uncomfortable position of having to ask Karen's daughter to let him remain there. Second, if Karen's daughter decided to sell the farm, Bill could not stop her because he doesn't own any part of it.

After discussing their concerns about these the shortcomings of these scenarios, Bill and Karen were eager to learn about the bypass trust plan that their attorney had mentioned.

Option #2 (Estate plan with a bypass trust)

Their attorney explained that an estate plan that adds a bypass trust to the wills is more complex than the previous estate plan. However, it provides some additional options. This more advanced estate plan would allow assets to be placed in a bypass trust when the first spouse dies. A bypass trust is so named because the assets are included in the taxable estate of the first to die. But in Karen and Bill's situation there is no estate tax because $2 million can pass without a tax. The assets in the trust "bypass" estate tax at the second death. That is, the bypass trust assets are not included in the taxable estate of the second spouse to die. While the surviving spouse is alive, he or she can enjoy the income from and the use of the assets in the bypass trust. After the second spouse dies, the trustee of the bypass trust distributes the assets of the bypass trust to the beneficiary indicated by the first spouse to die.

For example, Karen's will could state that if she dies before Bill, the land assets transfer to the trustee of a bypass trust for the lifetime benefit of Bill and the ultimate benefit of her daughter. The rules of the bypass trust, as administered by the trustee, allow Bill to use the land and enjoy the income from the land, but don't allow him to sell it. Under the terms of the bypass trust, the trustee distributes the land to Karen's daughter after Bill dies.

With the use of a bypass trust, Karen can ensure that Bill has use and benefit of the land until his death and that her daughter eventually receives the family farm. Because Bill and Karen's estate is below the $2 million exemption, the bypass trust was not used as a tax minimization technique. But it could have been used had their estate been larger.

Karen's will could still indicate that the other assets be divided equally between her daughter and Bill's son.

Discussion

The attorney suggested that Karen and Bill discuss the merits of these plans. Once they have determined which of these plans best suits their needs, they should have an attorney draft the appropriate legal documents to achieve their estate planning goals.

Other resources:

- Beneficiary Deeds In Montana (MT200707HR) http://www.montana.edu/wwwpb/pubs/mt200707HR.pdf
- Estate Planning in Montana: Getting Started (MT199508HR) http://www.montana.edu/wwwpb/pubs/mt9508.pdf
- Estate Planning: Wills (MT198906HR) http://www.montana.edu/wwwpb/pubs/mt8906.pdf
- Federal Estate Tax (MT199104HR) http://www.montana.edu/wwwpb/pubs/mt9104.pdf
- Life Estate: A Useful Tool in Estate Planning (MT200510HR) http://www.montana.edu/wwwpb/pubs/mt200510HR.pdf
- Property Ownership: Estate Planning (MT198907HR) http://www.montana.edu/wwwpb/pubs/mt198907HR.pdf
- Using a QTIP trust to Transfer Farm/Ranch Property to the Next Generation (MT200508HR) http://www.montana.edu/wwwpb/pubs/mt200508HR.pdf

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This MontGuide has been reviewed by representatives of the Business, Estates, Trusts, Tax and Real Property Section of the State Bar of Montana and recommends its reading by Montanans who are interested in bypass trusts.

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Disclaimer

This publication is not intended to be a substitute for legal advice. Rather, it is designed to help families become better acquainted with some of the devices used in estate planning and to create an awareness of the need for such planning. Future changes in laws cannot be predicted, and statements within this fact sheet are based solely upon those laws in force on the date of the publication.

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