THE NEW RELEVANCE OF INCOME TAXES IN ESTATE PLANNING AFTER THE AMERICAN TAX CUTS AND JOBS ACT

Article written by Trey T. Parker, Esq.

Historically, estate planning has focused more on estate, gift, and generation-skipping taxes, and less on income taxes. Therefore, most estate plans for affluent couples include what is often referred to as "A-B Trusts." Following the substantial changes made by the American Tax Cuts and Jobs Act (TCJA), including the increase in the estate tax exemption to $11.2 million per person and the retention of the Deceased Spouse Unused Exclusion Amount (also known as "Portability"), traditional A-B Trusts may not only be unnecessary for estate tax purposes, they may result in unnecessary capital gains tax liability.

In traditional A-B Trusts, the first-to-die's estate tax exemption is captured by allocating assets to the B Trust (also known as the "Credit Shelter Trust"). Among other things, the terms of the Credit Shelter Trust ensure that the assets allocated to it will not be included in the second-to-die's taxable estate. The trade-off, however, is that an asset that is not included in a decedent's taxable estate will not obtain an increase (or "step-up") in cost basis to its fair market value at the time of death for income tax purposes. Therefore, the opportunity for a second step-up in cost basis for Credit Shelter Trust assets and a corresponding reduction in capital gains taxation on the sale of the assets by the decedent's heirs is forfeited.

Previously, the loss of the second step-up in cost basis for Credit Shelter Trust assets was considered justified. Indeed, the tax rate differential between the estate tax rate (50-55%) and the capital gains tax rate (15-20%) was substantial. In the aftermath of TCJA, however, where the current estate tax rate is 40%, the current estate tax exemption is $11.2 million and "portable," and the top capital gains rate is now 23.8% (20% capital gains plus the new 3.8% healthcare surtax imposed on incomes exceeding certain thresholds), this is no longer the case. The following example illustrates the significant and unnecessary capital gains tax consequences that can occur by using A-B Trusts in the current tax environment.

Fred and June have a typical pre-TCJA estate plan, incorporating A/B Trusts to ensure the full use of both spouses' federal estate tax exemptions. Fred and June's combined estate is $1.5 million, of which Fred's share is $1 million.

Fred dies in 2018, and since Fred's share of the estate is less than the current $11.2 million estate tax exemption, Fred's entire $1 million is allocated to the Credit Shelter Trust as a result of the A/B Trusts tax planning provisions. Fred's appreciated assets that are allocated to the Credit Shelter Trust will receive a full step-up in cost basis as of the date of his death.

June dies 10 years later. In the intervening 10 years, June's share of the estate has grown from $500,000 to $700,000. At June's death, her beneficiaries will receive a full step-up in cost basis as of the date of her death.

The assets in the Credit Shelter Trust have grown from $1 million to $1.3 million. Fred's beneficiaries will not receive any step-up in cost basis for the appreciated assets in the Credit Shelter Trust when June dies. Instead, Fred's beneficiaries will inherit the Credit Shelter Trust assets with the cost basis of $1 million calculated as of Fred's 2018 date of death and not $1.3 million as of June's date of death. Thus, if Fred's beneficiaries sell these appreciated assets, they will be subject to capital gains taxes as high as $71,400 ($300,000 @ 23.8%).

Fred and June's story is only one scenario, but it illustrates the consequences of using A/B Trusts without considering the new relevance of income taxes after TCJA. I do not, however, want to imply that A/B Trusts are obsolete. In fact, A/B Trusts may still be appropriate in certain circumstances, because they can achieve many goals that are not available through the Portability alone. First, the generation-skipping tax exemption is not available with the Portability. Second, the Credit Shelter Trust offers asset protection for the surviving spouse by shielding such assets from creditors, predators, and future marriages. Third, the Credit Shelter Trust protects children in a blended family by "locking in" the remainder beneficiaries of the Credit Shelter Trust at the death of the first-to-die, so that the surviving spouse cannot disinherit the deceased spouse's beneficiaries. Finally, all appreciation of the assets in the Credit Shelter Trust following the death of the first-to-die passes estate tax free to the remainder beneficiaries.

If you have clients with A/B Trusts, you should consider having them in for a review to determine whether such provisions are still appropriate after TCJA. You may find that the A/B Trusts are necessary to achieve their goals. More than likely, you will find that removing the A/B Trusts provisions or adopting an in-between solution like an "A/B Disclaimer Trust," which gives the option to the surviving spouse whether to create the A/B Trusts, is more appropriate.