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WHY MARRIED COUPLES WITH ESTATE TAX PLANNING MAY NEED TO AMEND THEIR DOCUMENTS

Traditionally, when married couples did estate planning to reduce federal estate taxes, the first level of such planning usually involved a document (Will or Living Trust) which on the first death created an irrevocable trust with the decedent's assets equal to or less than the estate tax exclusion amount. Various names are used to describe that trust, such as a "Family Trust", a "B Trust", or a "Credit Shelter Trust." We will use the term Family Trust in this report as that is the term used in most of our documents.

This Family Trust was usually structured to provide support for the surviving spouse, but not be included in that surviving spouse's taxable estate for estate tax purposes.

The estate tax exemption was only $600,000 during most of the 1990's, with the excess being taxed at 37% to 55%. By utilizing such planning, a couple in the mid 1990's could have left $1.2 million to their children with no federal estate tax. This planning would have saved $235,000 in estate taxes.

The current exemption is $11.58 million (2020, indexed for inflation). Not only do fewer couples have taxable estates, but a new tax concept called "Portability" permits a surviving spouse to pick up her deceased spouse's unused exemption.

To obtain this increased exemption, the surviving spouse must file a federal estate tax return within 24 months of the decedent's death. Assuming that the first spouse to die left everything to his or her surviving spouse, and the estate tax return was timely-filed, the surviving spouse would have over a $22 million exemption (2018) on his or her death.

Family Trusts may be used for several purposes, but for those couples whose sole or primary purpose was to reduce estate taxes, such trusts may no longer be needed for that intended purpose. In fact, there are several disadvantages of such trusts, such as the requirement to segregate the assets, keep them separate from the survivor's assets, register the trust, notify the beneficiaries, obtain a new tax ID number and file annual trust income tax returns each year, and the loss of certain income tax benefits.

While these requirements may cost several thousand dollars, such costs were negligible when compared to the potential savings a decade ago, as discussed above.

Today, however, these costs may result in literally no benefit under the current estate tax structure. Furthermore, there are several income tax disadvantages to your spouse and your children as discussed below.

Example**:** On John's death, his half of the couple's assets, including the residence, was required to be distributed to the Family Trust for the benefit of Joan, the surviving spouse. On John's date of death, the residence was valued at $300,000, and there was a "step-up in basis" on John's half to $150,000.

The real estate market recovered and several years later Joan sold the home for $400,000. Joan can use her $250,000 personal residence exemption on the 50% of the home that she owns, but she CANNOT use it to reduce the gain on John's 50% owned by the Family Trust. John's 50% was sold for $200,000, resulting in a taxable $50,000 gain in the Family Trust, and perhaps $10,000 or more in actual tax payable.

If Joan didn't sell the house before her death, the house would pass to her children on her death. Because John's 50% was required to be distributed to the Family Trust, and the Family Trust is not included in Joan's taxable estate, there is no further step-up in basis on Joan's death. When the children sell the home for, say the same $400,000, the children will have that same $50,000 of taxable capital gain.

Undistributed net income in the Family Trust is often taxed at much higher rates than if such income were taxed to the surviving spouse. Example: John's $50,000 IRA was made payable to the Family Trust. Joan liquidated the IRA in December, but didn't distribute the proceeds to herself until April. That $50,000 will be taxed largely at 37% (2018) in the Family Trust, rather than at Joan's marginal rate of perhaps 15%, thus costing her an additional $10,000 or more in income taxes.

All of these negative tax consequences could have been avoided if John and Joan amended their documents to remove the requirement of funding the Family Trust on the first death.

You may ask, "But what if I just do nothing after the first death – Never retitle assets in the name of the Family Trust, never file an income tax for it, etc." The mere fact that you did not comply with the document on your spouse's death does not relieve you of any of the associated tax burdens. In fact, there are penalties for failing to file the tax return for the Family Trust, and that's in addition to any other tax liabilities mentioned above.

Even though your estate planning documents may have been perfectly drafted to meet your estate planning goals a decade or two ago, changes in the tax law now make such trusts unnecessary for estate tax planning purposes in most cases, and in fact, may carry added tax and other costs burdens with no likely offsetting estate tax savings.

That is why we STRONGLY recommend a review of your estate tax planning documents to determine if your "Family Trust" is still needed for its intended purpose. Not all of our married clients with Living Trusts need this amendment, but many do.

This Memo is offered as an informational summary only and does not constitute specific legal advice. You should consult with a legal professional before acting on the advice contained herein.