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Why Amending Your Estate Plan Could Create Significant Income Tax Savings

JANUARY 15, 2019| PUBLICATIONS

There are many reasons to have an attorney review your estate plan every few years. This is especially important for couples with estate plans that included estate tax planning provisions before the federal estate tax exemption significantly increased over the last decade. Due to the dramatic rise in the estate tax exemption, many couples who no longer face estate taxes should amend their estate plans to take advantage of future income tax savings.

Reality of Higher Federal Estate Tax Exemption. With the passage of the 2017 Tax Cuts and Jobs Act, the current federal estate tax exemption is $11,400,000 per person, so few estates will be subject to federal estate tax. However, as recent as 2001 the federal estate tax exemption was only $675,000 per person, meaning many people faced federal estate taxes. As a result, many couples created estate plans with estate tax planning provisions, such as bypass trust provisions (described below) to fully use the estate tax exemption at the death of the first spouse to die.

Do You Still Need a Bypass Trust Plan? Bypass trust plans are designed to reduce estate taxes by funding a bypass trust with assets up to the estate tax exemption amount, which will not be included in the surviving spouse's estate. Assets held in the bypass trust will avoid federal estate tax at each spouse's death. The remaining assets are then either held in a marital trust or distributed outright to the surviving spouse, and will not be subject to estate tax at the death of the first spouse to die (due to the unlimited marital deduction), but will be included in the surviving spouse's estate. These plans were common prior to 2012 when tax emptions were lower. However, with the substantially higher exemption amounts and the introduction of portability,[1] most estates will not be subject to any federal estate tax, so the focus should now turn to income tax savings.

Opportunity to Pass On Income Tax Savings. Upon death, the income tax basis[2] of an asset included in a decedent's estate is stepped up to equal the asset's fair market value on their date of death.[3] As a result, beneficiaries of the decedent's estate are treated as though they just purchased the assets they inherited, which can provide them with tremendous income tax benefits by avoiding capital gains on the appreciation of assets during the decedent's lifetime. However, assets held in a bypass trust do not receive this basis step-up upon the surviving spouse's death because these assets are not included in the surviving spouse's estate. As a result, couples with estates well below the estate tax exemption should amend their bypass trust plans to make sure all of their assets are included in the surviving spouse's estate. Otherwise, these couples may miss an opportunity to pass on income tax savings to their beneficiaries while gaining no estate tax advantage.

Options for Amending Existing Bypass Trust Plans. Couples have several options to update their estate plans to incorporate future income tax savings, some of which are more complex than others. A relatively simple option is to allocate all assets to a marital trust for the benefit of the surviving spouse or to distribute all assets outright to the surviving spouse, which will ensure that all of the couple's assets will receive a basis step-up at the surviving spouse's death. Another relatively simple option is to allocate all of the assets to a bypass trust and grant the surviving spouse a testamentary general power of appointment over the trust assets, so these assets will be included in the surviving spouse's estate. However, if the couple wants to build flexibility into the plan, they can allow the surviving spouse to disclaim some or all of these assets upon the death of the first spouse to die, or authorize their personal representative to make an election on the estate tax return, either of which may send assets to a bypass trust if exercised. Each of these options has advantages and disadvantages and the decision will likely depend on several factors such as family dynamics and the desire to protect assets from the surviving spouse's creditors, subsequent marriage, or mental incapacity. As a result, you should consult with an estate planning attorney to determine which option is right for you.

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Conclusion. It is generally recommended to review your estate plan every few years to make sure you still agree with the provisions and to account for changes in laws, your family situation, or your assets. Estate tax and income tax planning should also be considered during this process. If your existing estate plan includes bypass trust provisions and you no longer face federal estate tax based on the current laws, then updating your estate plan could save your beneficiaries significant income taxes in the future. Check with your estate planning attorney to help you determine what is best for your family.

[1] Portability is the ability for the surviving spouse to use the deceased spouse's unused exemption in addition to their own exemption.

[2] Income tax basis is generally the amount you invest in an asset and is used for computing the taxable gain or loss when the asset is sold. For example, if you purchase stock for $100 then your income tax basis in the stock is $100. If the stock is later sold for $150, the capital gain tax will be computed on the $50 of appreciation.

[3] This rule does not apply to qualified retirement plans.

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