legally speaking By **Patricia C. Marcin**, Esq. © 2021

WILLS, TRUSTS & ESTATES: PLAIN AND SIMPLE

"Is it Time to Consider Distributing Assets Held in Existing Trusts?"

It is not uncommon for a trust to have been created for a surviving spouse under a Will or revocable trust, in order to keep the assets in that trust out of the surviving spouse's estate for estate tax purposes, when the survivor dies. This is sometimes called a "credit shelter trust" or an "exemption trust." If such a trust was created upon the death of the first spouse at a time when the NYS estate tax exemption was well below the current estate tax exemption (currently, almost $6 million), you may wish to consider distributing some or all of the assets held in the credit shelter trust to the surviving spouse to save on potential income taxes resulting from capital gains.

A capital gain occurs if an asset is sold or exchanged at a price higher than its income tax basis. The income tax basis is the original purchase price of the asset plus the cost of improvements less depreciation. When someone dies, the assets that they own receive a "step-up" in income tax basis to the value at that person's date of death. For example, if Mary purchased stock for $1,000 and the value of the stock increased to $10,000 as of her date of death, the recipient of that stock under Mary's Will would take a "stepped-up" income tax basis in that stock of $10,000; if that recipient sold that stock for $10,000, he or she would recognize no capital gain.

When assets are placed in a credit shelter trust for a surviving spouse, the assets in the trust are not included in the taxable estate of the second to die spouse at death. However, one potential drawback is that the assets in the credit shelter trust do not receive a "step-up" in income tax basis upon the death of the second spouse to die. If the surviving spouse is older or in poor health, and the total value of the assets of the surviving spouse combined with one or more assets held in the credit shelter trust are significantly below the NYS estate tax exemption amount, it may be prudent for the Trustee of the credit shelter trust to distribute one or more assets held in the credit shelter trust to the surviving spouse prior to his or her death. This will result in the asset that has been distributed to the spouse from the trust being included in the taxable estate of the surviving spouse at his or her death, and such asset will receive a "step-up" in income tax basis.

For example, assume the first spouse to die, John, owned the house the couple lived in and it had a value of $1.5 million at John's death in 2008. Also, assume the house was placed in a credit shelter trust under John's Will for his wife's, Mary's, benefit for her lifetime. Mary is now age 91 and in poor health. The house in the trust is now valued at $2.5 million, and Mary has $2 million in other assets that she owns. Mary's estate planning documents leave everything to her son, Sam. If Mary dies with the house remaining in the credit shelter trust (which passes to Sam at Mary's death under the terms of the trust), and Sam then sells the house for $2.5 million, he will recognize a capital gain of $1,000,000. If, however, the house had been distributed from the trust to Mary prior to her death, the house would receive a full "step-up" in income tax basis, so that Sam would recognize no gain on the sale. Since Mary's assets (the house and her $2 million of other assets) total $4.5 million, there is no NYS estate tax (or federal estate tax) due, and Sam has gotten the benefit of the "step-up" in basis on the house, a tax savings of potentially $300,000 or more.

If there is a trusts or estates topic that you would like to know more about, please feel free to email me at pmarcin@farrellfritz.com with your suggestion and I will do my best to cover it in a future column.

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