Should Assets Stay in a Nonmarital Trust or Be Distributed to a Surviving Spouse?

by Dennis C. Reardon, JD, LLM, CLU, ChFC

Abstract: With the twists and turns that have affected both estate tax planning and income tax planning, certain long-held assumptions may need close examination. A variety of factors may sustain the continuation of a nonmarital trust. However, in certain cases it may be best to reconsider, particularly if the remainder beneficiaries receive no estate tax benefit and wonder why they wound up with income tax expense that could have been avoided.

The enactment of the American Taxpayer Relief Act of 2012 (ATRA) became effective in 2013, and now that we have just passed April 15, 2014, many Americans are directly experiencing the tax increases delivered by ATRA and the Affordable Care Act. At this point, most financial planners are well familiar with the fact that joint filers with taxable income over $457,600 face a marginal federal income tax rate of 39.6 percent and a tax on long-term capital gains of 20 percent for those gains comprising taxable income over $457,600. The 3.8 percent Medicare tax, which is actually just another type of income tax, has also become a factor in planning.

Nonmarital Trusts: Maintain or Terminate?

A nonmarital trust (trust) might pay income to, or accumulate income for, a surviving spouse. If permitted by the terms of the trust, it would tend to accumulate income if the spouse would be likely to have estate tax payable at the spouse's subsequent death. The effort to accumulate funds in the trust for the spouse who didn't really need the income made great sense when the estate tax exemption was relatively low ($1 million or $2 million), estate tax rates were rather high (50 or 55 percent), and federal income tax rates were lower than today (no more than 35 percent for ordinary income and 15 percent for long-term capital gains).

We now live in a different world. It does remain true that the wealthy spouse who faces a taxable estate and is in the highest income tax bracket without receiving income from the trust may just as well have the trust accumulate income. However, in many situations, it will be better to distribute income to the spouse. Keep in mind that the trust is now taxed at the highest income tax rate when its taxable income exceeds $12,150. Any long-term capital gains comprising taxable income over $12,150 to the trust are taxed at 20 percent. With the much larger estate tax exemption available today, it will often be advisable to distribute income to the spouse who is a lifetime beneficiary. While my general preference in drafting a nonmarital trust has been to have income distributed to the spouse at the discretion of the trustee, many trusts nonetheless direct that all income be paid to the spouse.

For many years, estate planners were forced to qualify their advice regarding estate tax planning by expressing uncertainty as to whether the federal estate tax would be in existence at all. As the saying goes, never say never, but we are now led to believe that the estate tax law has permanence, or stability, at least, for the foreseeable future. Yes, anything (or nothing) can happen in Washington, but it appears unlikely that major changes will be made to the federal estate tax law anytime soon. One indicator of Congressional commitment in this regard is the indexing of the estate tax exemption. Whatever prognostication may be made as to the future of the estate tax law, not many individuals would say that the exemption will be substantially reduced, rather than indexed to a cost-of-living standard.

Many of us have clients who are no longer worried about the estate tax law, even though they were sufficiently concerned some years ago to have trusts set up specifically designed to reduce estate taxes in the future. Suppose that your client is widowed and has a level of wealth at a certain age that makes it seem improbable that estate tax liability will be incurred when that client dies. Suppose further that your client lives in a state which has no estate or inheritance tax, or which presents the prospect of a smallish state estate tax at the client's death.

Income Tax Planning Is a Greater Concern

Why keep a trust in effect for a client in this position? While there may be nontax reasons that should be considered, for the moment we will concentrate on the tax planning aspects of the trust. In that regard, the income tax effects of the trust may be its kiss of death. Specifically, when the surviving spouse dies, the basis of the trust assets for income tax purposes may be the same as or similar to what it had been at the death of the spouse who died first. If the trust is terminated, and the assets are distributed to the surviving spouse, that spouse's estate would have the benefit of a stepped-up basis if the spouse owns them at death.

Consider the potential tax savings that the trust termination provides. No federal estate tax may be payable whether the trust continues or ends. The income tax results may be a bit better, somewhat better, or absolutely better than if the trust had remained in effect. How so? The more low-basis assets that are held by a person at death, the more income tax that can be avoided by his or her beneficiaries after death. Also, while I have referred to a step-up in basis and unrealized gain, in a given case there may be unrealized loss and a corresponding step-down in basis. If assets are sold after death for less than the stepped-down basis, a tax loss will occur. It may also happen that assets with unrealized loss at death may be subsequently sold at a value that exceeds the stepped-down basis, but is still less than the purchase price. For example, if an individual buys an asset for $10 and it decreases to an $8 value upon death, but is later sold by the individual's estate for $9, no gain or loss is realized.

In contemplating the possible termination of a trust, the overall portfolio has to be considered. Investment advisors typically provide basis information as to each security on an account statement. The portfolio's turnover rate will be very significant in making judgments about income tax basis. If the investment manager trades actively, gains may be realized more frequently, and the accumulation of low-basis assets will be less prevalent. However, in many instances, active trading does not occur, avoiding capital gains tax is a more typical approach, and the investment manager may let winners ride so that major gains occur on paper. This scenario is especially apt to occur when there is no need to sell securities to generate cash for distribution to the spouse as the primary trust beneficiary.

A number of factors may influence the amount of income tax savings that will be ultimately derived from the termination of a trust. The life expectancy of the surviving spouse must be taken into account when termination is considered. The measure of income tax savings will not be known until the spouse dies (and assets are subsequently sold). However it plays out, the distribution of appreciated assets from the trust to the spouse should produce a better income tax result than if the trust remains in effect until the spouse dies. The composition of trust assets and the overall investment strategy will dictate income tax results along the way. If the trust's investment portfolio has considerably more stocks than bonds or cash, the unrealized gain is quite likely to be greater than if assets with a more stable principal value comprise the investment roster.

Even So, Nontax Factors May Rule

If minimizing taxes were the only concern, and the prospect of federal estate taxation of the trust's primary beneficiary could be factored out, the restoration of a stepped-up basis would make the trust termination a slam dunk. But not so fast, maybe. When direct ownership of assets is given to the surviving spouse, the power of disposition comes with it. The spouse may decide to bequeath the assets to someone other than the remainder beneficiaries of the trust. To point to a dramatic example, if the widowed spouse had been in a second marriage, he might decide to leave the assets he received as a result of the trust termination to his children, rather than to hers or theirs. For that matter, the surviving spouse in a first marriage may transfer assets under his will so as to make the decedent spin in her grave. A child may be favored or disfavored because of events that occurred after the death of the spouse who died first. Assets might even be transferred to a new spouse. If the widowed spouse becomes mentally weakened, all sorts of mischief and untoward results may occur.

In many cases, a proposed transfer of assets to the surviving spouse may not occur so easily. As an attorney who advises clients in Pennsylvania, I often recommend that the surviving spouse be the sole beneficiary of the trust during the spouse's lifetime. (In most cases, a Pennsylvania inheritance tax rule pertaining to trusts for the sole use of a surviving spouse drives us in that direction.) In other states, the surviving spouse and the decedent's children may be trust beneficiaries during the spouse's lifetime. To terminate the trust, the trustee will require both the current beneficiaries and the remainder beneficiaries to sign releases. The other beneficiaries may not want the spouse to receive the assets, and no termination may occur.

Even if all of the trust beneficiaries agree, a corporate trustee may be leery about the prospect of a trust termination. The trustee's resistance may be attributed to one concern or another with regard to the beneficiaries or it could stem from a reluctance of which the trustee dare not speak its name. Specifically, the corporate trustee that terminates the trust may lose investment control over the assets and its compensation for investment management. That may not matter if the spouse who receives the assets is willing to continue the investment relationship. In today's world, it is often the case that the lifetime beneficiary has the right to remove and replace the trustee, so a trustee with misplaced loyalty may be shown the door in favor of a more enlightened successor.

Time to Think Twice?

With the twists and turns that have affected both estate tax planning and income tax planning, certain long-held assumptions may need close examination. A variety of factors may sustain the continuation of a nonmarital trust. However, in certain cases it may be best to reconsider, particularly if the remainder beneficiaries receive no estate tax benefit and wonder why they wound up with income tax expense that could have been avoided. ■

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