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Step Up In Basis With A-B Trusts

By Merwyn J. Miller, Attorney-at-Law

Introduction

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Dear Mr. Miller: My Dad passed a few months ago. My Mom preceded him back in 2000. They had one of those A-B Trusts. You know, the one where at the first death, the assets are split into two pots: a Survivor's side and a Decedent's side. That was done when Dad died and we faithfully helped Mom keep the two sides separate.

The Decedent's side has the house and a whole lot of stock investments. Even with the crash of a few years ago, they have appreciated considerably since Dad passed. Now I am being told that since these assets were on the Decedent's side, when we sell these assets we are going to have to pay tax on the gain. I thought when Mom passed everything got a whole fresh start with the IRS. To say the least, I am really upset here. This could cost us \$125,000 in taxes. **Upset Child**

Dear Upset Child: The answer is going to be a mix of good and bad news.

Step Up In Basis Rule: When one dies, the general rule is that any assets that that person owned at death will receive a new step up in income tax basis to the fair market value at the date of death. So if the asset was worth \$500,000 when your Dad died and \$1 million when your Mom passed, the \$500,000 of capital gain would ordinarily be taxed. Between Federal and California, that tax rate might be in the 25% bracket resulting is a tax of \$125,000. However, because of the step up rule on death, all of the pre-death appreciation would be forgiven, saving the entire \$125,000 tax.

Decedent's Trust Step Up: There are 1000's of different configurations of trusts. So without seeing the specific trust document it is impossible to give you a definitive answer. Nevertheless, typically Decedent's Trusts (also referred to as "B" Trust, Family Trust, or Credit Shelter Trust), allow the income to the surviving spouse for her life with the ability

to obtain principal only if needed to maintain the survivor's quality of life (often defined as health, education, maintenance, and support needs). Because of these terms, the assets in the Decedent's Trust are not "owned" by the Survivor and, therefore, do not typically receive a new basis when the survivor dies.

Death Tax Focus: The Decedent's Trust is typically configured so that death taxes on the death of the Surviving Spouse can be reduced or avoided. Given that the death tax exemption (the amount that one can have without there being a death tax) has risen from \$675,000 in 2000 to \$5 million this year, many estates that originally had a death tax concern do not by the time the second spouse passes. That appears to be what occurred in your parent's estate.

Changing the Focus to an Income Tax One: Ok, here comes the good news. If no Federal Estate Tax return was filed with the IRS when the first spouse died, then one can be filed now. And in that return, one can elect to have the Decedent's Trust focus on income tax rather than death tax. This is called the Qtip Election. The technicalities are way beyond the scope of this article. Nevertheless, even though no estate tax was due when your Dad died, an Estate Tax return for his estate can still be filed now (even though it would be after the deadline) with the Qtip election being made. By doing so, the assets in the Decedent's Trust are allowed to receive the step up in basis. However, depending on the wealth of your Mom and Dad, this may result in a death tax being due on your Mom's estate.

Getting Help: Interestingly, many income tax preparers with whom I have discussed this option are totally unaware of it. Obviously, this is a complex option to carry out and you need professional advice. I would suggest a very competent estate planning attorney should be your choice.

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