

## **DRAFTING FLEXIBLE TRUSTS TO TAKE ADVANTAGE OF STEP-UP IN BASIS**

With the federal estate tax exemption currently at \$5.34 million per person (as of 2014) and with portability made permanent (discussed in previous newsletters available on our website), most couples can pass their unused federal estate tax exemption to the surviving spouse, and on both spouses' deaths leave their entire estates to their families, free of federal estate tax, without the need for any planning with credit shelter trusts or equalizing of assets between spouses. In addition, when each spouse dies, the basis of most assets (assets like IRA's are an exception) are "stepped-up" to date of death value so that capital gains until date of death are eliminated (the basis of assets may be stepped-down as well). This step-up in basis can be a significant savings since federal long-term capital gain rates are 20% for those in the highest income tax bracket plus a 3.8% net investment income tax for certain high income taxpayers, and Connecticut income tax of up to 6.7%.

There are many reasons why a married couple may wish to have a trust for the surviving spouse despite the availability of portability and the large federal estate tax exemption, such as taking advantage of the Connecticut \$2 million estate tax exemption, sheltering post-death appreciation from future estate taxes, having the flexibility to benefit children and grandchildren in addition to the surviving spouse, and protecting assets from future creditors and future spouses. For married couples with combined assets of over \$4 million, setting up a \$2 million credit shelter trust for the surviving spouse rather than leaving those assets outright may save up to \$240,000 of Connecticut estate tax on the surviving spouse's death.

A potential downside of setting up the credit shelter trust is that assets in the trust do not receive a second step-up in basis on the surviving spouse's death. This disadvantage can be mitigated by broad trustee powers which we have added to our trust documents. The trustee has the power to distribute low basis assets to the spouse prior to his or her death. The trustee may also grant the spouse the power to decide how the trust assets will pass at his or her death (a "general power of appointment"). Granting a general power of appointment allows the trust assets to be included in the spouse's estate without the necessity of distributing the assets to the spouse.

Whether it is advisable for the trustee to distribute assets or grant the spouse a general power of appointment will be different for each couple depending on the size of their estates, the income tax basis of the trust assets, the likelihood that an asset will be sold, and the likelihood that the surviving spouse will benefit the same people as the first spouse to die. The trustee will need to consider the potential that the distribution will increase estate taxes payable at the surviving spouse's death, versus the potential capital gains tax on a future sale of the asset if it is retained in the trust.