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The Role of Capital Gains Tax in Estate Planning

How Eliminating Your Old "A-B" Trust Plan Wills Save Your Beneficiaries

It is important to understand how capital gains on the sale of capital assets are calculated and taxed. It is particularly important to educate clients who still have the largely unnecessary estate tax planning trusts so they understand why those trusts generally should be revised to remove those provisions. I am referring to those trusts that provide on the death of the first spouse for the estate to be divided into separate parts and to hold the deceased spouse's share of the estate in an irrevocable trust for the benefit of the survivor, then to pass those assets along to the children or other beneficiaries after the survivor's death.

These are called "A-B" trusts which were invented to keep as much of the family estate as possible or necessary out of the surviving spouse's taxable estate so that the maximum estate value could be passed to the next generation. This plan (which had and have many variations and complexities) was common prior to 2010 when the estate tax law changed to increase the personal exclusion (called the "unified credit" against gift and estate tax) from gift and estate tax to a dramatically larger sum that effectively eclipsed the whole value of many family estates.

When this strategy was widely used, a majority of family estates had a greater value than the exclusion amount, or were expected to exceed that amount when the first spouse would die in the future. However, the exclusion amount has continued to grow and has since overtaken the value (including the expected value) of most of our estates. The last tax law change increased the exemption from $5.45 million per person to $11.5 million per person. That increase will remain in effect until it reverts to the $5.45 million exemption amount in 2026. So, most of us will not have any estate tax problems by the time we pass along.

Few estate plans not require the restrictive A-B strategy. Yet there are many tax planning trusts still out there that still provide for this A-B strategy. Those plans have not been reviewed and updated. Now, failing to do that will be to the financial detriment of your surviving spouse and your ultimate beneficiaries.

However, explaining why those provisions should be eliminated from your trust or will requires some understanding of capital gains taxation and the concept of "basis" which now cause the A-B strategy to backfire to the detriment of your ultimate beneficiaries if it is not eliminated. Because it is my experience that this conversation tends to put the client's mind in neutral, I have created this written explanation as a reference to take home and study until the lightbulb of understanding clicks on.

So, I will lead you through these concepts with examples that you can use to quantify your own situation and, hopefully, appreciate why your old A-B plan is irrelevant and harmful to your goals.

Basic Capital Gains Taxation.

In general, you must report the amount of "profit" you receive when you sell a capital asset, such as your home. Simply stated, you find the amount of taxable profit (capital gain) by subtracting your "*basis*" in the property from the sale price. Thus, the concept of your tax basis is the central factor in determining how much of your profit on the sale is taxable.

If, for example, you sell your home during your lifetime, your basis in the property will be what you paid to buy the home plus the cost of any improvements you made while you owned it; such as, a new roof. This "*appreciation*" in value is called capital gain for income tax purposes.

(Note: You can reduce the amount of that profit once in your lifetime by subtracting your lifetime exclusion from gain: $250 per person/$500 per couple.)

Here is an example of the capital gain calculation for the sale of your home during your lifetime.

In this example, husband and wife are selling the family residence that they purchased for $150,000 and added improvements at a total cost of $80,000. The net proceeds of sale are $900,000. Neither spouse has used their $250,000 lifetime exclusion from capital gain. Their taxable income exceeds $39,375 so their gain is taxed at 15%.

Sale price net closing costs	$900,000	
Basis	$230,000	(what you paid + improvements)
Capital Gain	$670,000	(amount of appreciation or "gain)
Unused lifetime exclusion	($500,000)	
Taxable Gain	$170,000	
Tax at 15%	**$170,000**	
Net profit	**$799,500**	

Long-term capital gain tax rates for 2019

	Single Filer	Joint Filers
0%	$0-$39,375	$0 - $78,750
15%	$39,376-$434,550	$78,751-$488,850
20%	$Over $434,550	Over $488,850

Capital Gain Rules After Death.

Assets that you still own at the time of your death will be passed along or sold after your death. You need to understand the role of capital gains tax law and concepts such as "*adjusted basis*" or "*stepped-up basis*" to appreciate how these rules affect tax minimization for your beneficiaries.

Step-up. All of the assets you own at the time of your death will receive a new tax basis equal to the fair market value of the asset as of the date of your passing. This means that the basis of the asset in your hands before your death will be adjusted up to that date of death value. The effect of this is that the appreciation that would have been taxable had you sold the asset before your death will be erased. Your estate and your beneficiaries will use the new, adjusted basis when the asset is later sold.

The amount of the asset's basis that gets stepped up will be the value of your interest in the property at the time of your death. If this is your separate property (say, an asset you inherited), then the entire value of the asset on date of death will be the new basis. If you are married and this is your community property, then the whole value of the asset will be stepped-up even though you and your spouse each own a one-half interest in the property. If you own a partial interest in the asset (say you are one of several partners who own the property together), then only the value of your interest receives the step up in basis; the other interest owners retain their own basis.

Knowing these basis rules is important in estate planning for your benefit and for the benefit of your estate and your beneficiaries following your passing.

Characteristics of the A-B Plan

I am going to lead you through a typical A-B trust plan, which may be written in your living trust or your wills, focusing only on the basis strategy and ignoring the many variations that will affect the implementation of the plan when the first spouse dies. It is this core principle in the context of today's

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estate tax law that should urge you to change your plan to eliminate the A-B plan, unless your estate significantly exceeds the exemption amount.

You're A-B trust plan, whether in your living trust or your wills, requires that the estate of the first spouse to die (called the "deceased spouse") will be retained in an irrevocable trust (Trust A – the "Decedent's", "Bypass", "Family" trust, etc.) that provides for the surviving spouse but is not her or his asset, so it will not be included in her or his estate when determining if there is any estate tax payable from the surviving spouse's estate. The surviving spouse cannot dictate the ultimate distribution of Trust A unless given the specific power to do so. Otherwise, that disposition is unalterable. Trust B (the "Survivor's Trust" or some other name) will be a revocable trust under the surviving spouse's control., including its ultimate disposition.

What is the Problem?

The irrevocability of Trust A causes a problem in estates valued under the $11.6 million exclusion amount. While the value of the assets allocated to Trust A will have their basis stepped up to their fair market value as of the deceased spouse's death, their basis does not get the step-up on the surviving spouse's death and will be passed along to the ultimate beneficiaries without adjustment.

The basis of the assets allocated to Trust B also will be stepped up at the same time. But, because Trust B is revocable (like any other living trust), the assets in Trust B at the surviving spouse's death to receive a further step-up to fair market value as of that date. So, any appreciation in Trust B assets between those deaths is eliminated for the ultimate beneficiaries.

Here is an example to illustrate the effect on the basis of assets passing from Trust A and Trust B to the couple's children after the death of the surviving spouse.

Mom and Dad own their family residence that they purchased for $200,000 and added $120,000 in improvements by the time of the first spouse's death. Their trust provides for the division of the family assets between Trust A and Trust B. We will assume that the asset is the couple's community property, so 50% of its value will be allocated to each trust. In this example, Dad is the first to die.

This fair market value of the residence at Dad's death is $1,200,000 so that is the new basis of the property in each trust. However, that basis in Trust A (Dad's trust) will not receive a further adjustment following Mom's passing. Mom passes several years later when the fair market value of the residence has increased to $1,800,000.

A-B Trust Plan		Basis in Bypass Trust A	Basis in Survivor Trust B	Basis for Beneficiaries
Total value of residence at Dad's death	$1,200,000	$ 600,000	$ 600,000	
Fair market value at Mom's death	$1,800,000		$ 900,000	$1,500,000

Simple Family Trust		Basis on Dad's Death	Basis on Mom's Death	
Total value of residence at Dad's death	$1,200,000	$ 1,200,000		
Fair market value at Mom's death	$1,800,000		$ 1,800,000	$1,800,000

In this example, the ultimate beneficiaries will receive the property with a combined basis of $1.5 million under the A-B Plan and $1.8 million without the plan. This $300,000 difference will cause a capital gains tax that, at 15%, will be **$45,000** in addition to the tax on the gain of the property in their hands before it is ultimately sold.

That extra $45,000 in capital gains tax (in today's dollars) is unnecessary if you will remove the A-B plan from your trust or will.

If you want additional explanation or have questions, please bring them up at one of our meetings.