STUB Trusts Are the Ticket to Increasing Basis

by
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With the passage of the law commonly called the Tax Cuts and Jobs Act (TCJA) in December 2017, Delaware bankers have noticed a change in the estate planning landscape. Many of their clients have suddenly become less concerned with getting assets out of their estates and more concerned with income tax basis. The TCJA doubled the applicable exclusion, below which no estate or gift tax is payable. After the 2019 inflation adjustment, clients can now pass $11.4 million to their loved ones free of transfer taxes. With proper planning, a married couple can fully utilize both exclusions, resulting in a $22.8 million tax-free wealth transfer.

The TCJA creates a planning opportunity for clients who had already used most or all of their applicable exclusions. Further lifetime gifting will make sense for many, but the answer will not be the same for everyone. One strategy to consider is creating a Step-Up in Basis (STUB) trust, also known as a Section 1014 trust.

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For Whom Might a STUB Trust Make Sense?

Clients with low-basis, high-value assets may be more concerned with future capital gains taxes than they are about estate taxes. These assets might be publicly traded stocks or interests in closely held businesses. Clients who might sell these assets before death are candidates for STUB trust planning.

An older individual expected to die with an estate well below the applicable exclusion is an integral part of the plan. This is often the client's parent, grandparent, aunt or uncle. The person may even be an in-law of or unrelated to the client. For simplicity, we will refer to this older individual as Grandparent for the remainder of this article.

How a STUB Trust Works

STUB trusts are like snowflakes in that no two are alike. The objective is for the assets of the STUB trust to be included in Grandparent's estate, which results in the basis of the assets being reset to fair market value on Grandparent's date of death with no estate tax due.

Several techniques can accomplish the goal. One option favored by many is for the STUB trust's governing instrument to grant Grandparent a testamentary power to appoint the trust's assets to the creditors of his or her estate. Despite the narrow scope of this power and Grandparent's inability to see the results of exercising it while alive, it is a general power of appointment and causes the STUB trust's assets to be included in Grandparent's estate. Grandparent likely would not exercise such a power, and the power does not allow Grandparent to alter the client's wishes for the ultimate disposition of the trust's assets in a meaningful way.

A STUB trust typically provides for discretionary distributions of income and that the trustee may make principal distributions based on an ascertainable standard. Grandparent and the client's descendants are usually named as beneficiaries, but it is not expected that anything will be distributed to Grandparent. While Grandparent is still alive, trust assets can be accessed to pay for descendants' expenses.

The client's spouse may also be named as a beneficiary of the STUB trust. If the client and his or her spouse each create a STUB trust, these trusts can effectively function as paired spousal lifetime access trusts (SLATs). If this strategy is pursued, the usual precautions applicable to SLATs, notably that they not have identical provisions, must be observed.

When Grandparent dies, the trust may terminate and distribute its assets to the client's descendants. Since the basis will have been adjusted to the fair market value on Grandparent's date of death, a sale would likely result in little gain or loss.

Alternatively, the trust could continue after Grandparent's death. This may be an attractive choice, if the client's descendants are young. If it meets the client's planning objectives, the STUB trust could even morph into a dynasty trust, since it will be exempt from generation-skipping transfer tax. The STUB trust could sell any of its assets after Grandparent's death with negligible tax consequences. This provides an excellent opportunity to rebalance the trust's portfolio.

If the client's spouse is a named beneficiary, and the STUB trust is intended to serve as a SLAT, the trust will ordinarily continue at least until the spouse's death. The spouse will have access to discretionary distributions, if the assets are needed. Further, since the descendants are permissible distributees, the trust can pay for descendants' expenses the client would otherwise have paid from personal funds. This includes items that may have been taxable gifts had the client paid them directly.

For unmarried clients who want the option to regain control over the assets, Grandparent's power of appointment may also allow the trust's assets to be appointed back to the client. This can be very effective, if the client does not expect to have a taxable estate. Provided Grandparent cooperates by changing his or her will, this decision can be revised as often as desired until Grandparent dies or becomes incompetent.

There is risk that, if not enough time passes between the gift to the STUB trust and Grandparent's exercise of the power of appointment in favor of the client, the IRS might collapse the arrangement and disallow the step-up in basis. Therefore, Grandparent should not document the exercise of such a power in his or her will immediately after the trust is created. Further, no step-up in basis is available for any assets returned to the client within one year of gifting them to the STUB trust.

A client who wants to regain the ability to access the assets after Grandparent's death but expects to have a taxable estate can grant Grandparent a power to appoint the assets to a trust for the client's benefit, the terms of which can be described in the STUB trust's governing instrument.

Although many clients might find it preferable, a STUB trust with the client named as the residuary beneficiary will not work. This would create a reversionary interest and make the client's transfer to the trust an incomplete gift, resulting in no step-up in basis.

Managing the STUB Trust

Many clients may consider naming a spouse or a sibling to act as trustee. Although they would serve without demanding a fee, the benefits of using a professional trustee are many. A high quality professional trustee offers competence, experience, attentiveness and objectivity, making the professional trustee more capable of managing investments, keeping records, accounting to beneficiaries, communicating with tax and legal professionals, and resolving disputes. A corporate trustee also offers longevity and certainty of situs in a chosen jurisdiction.

While it is often comforting to a settlor to name a spouse and a trust company as co-trustees, care should be taken to consider the state tax consequences. The spouse's residence in a state could cause the STUB trust to become taxable in that state. This would be the case in California and Virginia, to name two. If the spouse moves, this could create a new state income tax problem for the trust.

Delaware is an excellent choice for the situs of a STUB trust. It offers flexible laws and access to the highly respected Court of Chancery for dispute resolution. Depending on where the client and trust beneficiaries live, choosing a Delaware trust company as trustee could result in the trust paying no state income tax, even in the client's home state.

Risks Associated with STUB Trusts

The TCJA provision doubling the applicable exclusion is scheduled to sunset after 2025. No one knows whether Congress will extend it, make it permanent or allow it to expire. The conservative approach is to choose an individual as Grandparent who is not expected to have an estate in excess of the applicable exclusion, even if doubling the exclusion sunsets. An incorrect assumption that Grandparent will die before 2026, could lead to joy that a loved one is still with us and distress that there is a tax cost associated with that.

The sunset of doubling the applicable exclusion may also affect whether the STUB trust's assets should be appointed back to the client. Since the client will use some of his or her applicable exclusion on the gift to the STUB trust, there may be none available to shelter the assets he or she receives, after Grandparent dies. If Grandparent has already appointed the trust's assets to the client in his or her will and has become incompetent, it may not be possible to change the will, and the client could end up with an estate tax, even though the estate would have been less than the applicable exclusion had there been no STUB trust.

For this reason, it is often preferable for Grandparent to appoint the assets to a trust for the client's benefit rather than directly to the client. If it becomes clear after Grandparent's death that the client's estate will not owe any tax, a provision in the governing instrument allowing a non-adverse trustee to terminate the trust can be invoked. This could create another step-up in basis on the assets at the client's death, if he or she still holds them.

The client may be concerned about the consequences of the relationship with Grandparent souring. If Grandparent dies with large debts, for instance, from a judgement related to an environmental matter, he or she could unexpectedly appoint the assets of the trust to his or her estate's creditors with the intention of spoiling the client's plans for their disposition. To avoid this, the power to do so can be made exercisable only with the consent of a non-adverse party, such as a Delaware trust company. As long as the party whose consent is required has no interest in the trust, Grandparent's power of appointment will remain a general power and cause the assets to be included in his or her estate.

Action plan

Delaware bankers should evaluate which of their clients might benefit from creating a STUB trust. At the next meeting with a candidate client, the banker can explore the possibility of creating basis without paying estate tax. The banker can gauge the client's interest and discover whether anyone fits the Grandparent profile.

If the client is interested in a STUB trust, the banker can set the planning process in motion with the client's tax and legal

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advisers or recommend competent professionals, if the client has no advisers. Since the STUB trust can take many forms, detailed discussions with the client will be needed to help him or her understand the options and choose the right provisions to include in the governing instrument.

Once the plan is fully developed, the STUB trust should be funded with high-value, low basis assets. The trust will need its own tax ID number and be required to file an income tax return. The client will need to file a gift tax return. If it is intended that Grandparent will exercise the power of appointment, care must be taken to ensure this is done at the correct time. Clients who have a Delaware banker on their team will find management of the STUB trust relatively painless.

Conclusion

Every Delaware banker likely has clients who can benefit from creating a STUB trust. Bringing this planning option to a client's attention adds value to the other services a banker provides. While the design of STUB trusts can be flexible enough to suit the varying needs of many clients, there are also very expensive pitfalls looming, and it is important to involve competent tax and legal advisers in the planning process.

Peter Hopkins is a Tax Manager at Cover & Rossiter. Cover & Rossiter is one of the first and most respected full-service CPA & advisory firms in Delaware, providing tax, audit, trust, and accounting services to individuals and families, businesses, nonprofits, and captive insurance companies. The firm was recently honored with the 2018 Marvin S. Gilman Superstars in Business Award by the Delaware State Chamber of Commerce.