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Estate planning for potential political, tax and economic changes: A guide for trustees

With the current COVID-19 pandemic and the upcoming Presidential election, we are living in very uncertain economic and political times. This uncertainty places additional burdens on trustees of trusts seeking to fulfill their fiduciary obligations to the trust beneficiaries. In this article, we focus on how trustees can protect against liability under New York's Prudent Investor Act (the "Act") in light of political, tax and economic changes.

The Act provides legal guidelines for trustees when making investment and distribution decisions. At the outset, it is important to note that the Act is focused on a trustee's conduct, not necessarily on the results of a trustee's decision. The Act recognizes that even a great trustee can make the "wrong" decision from time to time. The Act provides that even if a trustee is wrong, the trustee should not necessarily face liability under the Act if the trustee followed a reasonable course of conduct in arriving at that decision.

When contemplating economic, tax and political uncertainty, a reasonable course of conduct would generally involve considering the uncertainty and documenting the decision-making process in light of that uncertainty.

With this background in place, here are some items we think trustees should be considering now.

The upcoming presidential election could lead to seismic shifts in the estate and gift tax regime. The federal estate and gift tax exemption is at an historic high. The exemption for this year is $11.58 million per person and $23.16 million for a married couple.

For the duration of its existence, the estate tax regime has functioned as a tax on the transfer of assets on death. These transfer taxes currently go hand-in-hand with a substantial tax income tax benefit. As a reward for being subject to transfer taxes, any asset subject to transfer tax in a decedent's estate currently receives a step-up in income tax basis to fair market value as of the decedent's death. This rule, sometimes jokingly referred to as "the angel of death," wipes out unrealized capital gains in assets owned by a decedent.

However, Democratic presidential candidate Joe Biden has proposed eliminating the step-up rule. This would result in beneficiaries receiving assets with carry-over basis, which would be subject to capital gains tax on a subsequent sale using the decedent's own basis in the asset. At this stage, it is not clear what effect the elimination of the step-up rule would have on the estate and gift tax regime as a whole. It is clear, however, that the elimination of the step-up rule would be a substantial deviation from the historic transfer tax structure and could fundamentally change estate planning in the U.S.

TAXING MATTERS
Josh Gewolb

From a trustee's perspective, the elimination of the step-up rule could affect trust administration in several ways. First, marital deduction (or "QTIP") trusts, which are created for the benefit of a surviving spouse, are structured to be included in the surviving spouse's own estate on his or her later death. These trusts can be funded and invested in a manner that takes advantage of the resulting step-up in income tax basis on the death of the surviving spouse. If the step-up rule is eliminated, a trustee should consider whether investment strategies should be altered to more aggressively manage asset basis during the trust administration, given that no step-up in income tax basis might be available on the surviving spouse's death.

In addition, many recent trusts will have been structured to give the trustee the ability to grant a beneficiary a general power of appointment. This general power would cause inclusion of the trust assets in the beneficiary's estate and would cause the trust assets to receive a step-up in income tax basis on the beneficiary's death. If the step-up rule is eliminated, any general powers of appointment that were granted in this manner should be reconsidered.

Beyond the potential elimination of the step-up rule, candidate Biden has also proposed eliminating the current reduced long-term capital gains rate for taxpayers earning over $1 million. The proposal is to tax capital gains as ordinary income for these high-income taxpayers. Although this has not been expressly stated, there is no reason to expect that trusts would be an exception from this rule. Trustees should consider whether trust investment strategies should be adapted if the capital gains rate is changed in this way.

COVID-19 pandemic

The Act also requires the trustee to consider a beneficiary's needs for present and future distributions. The COVID-19 pandemic has dramatically affected the economy and caused gyrations in the stock market. Trustees should consider whether the pandemic has affected a beneficiary's need for trust distributions and whether existing distribution schedules should be adjusted.

For example, if a beneficiary has lost work because of the pandemic, that beneficiary may need additional trust distributions to provide for his or her support. Not only could additional distributions be required to provide for the beneficiary, but additional distributions could also be income tax efficient if the trustee can shift more trust income to a beneficiary while he or she is in a lower income tax bracket as a result of lost income.

From the Act's perspective, a trustee should have a process in place to gather information about a beneficiary's personal circumstances sufficient to perform this type of analysis. Trustees should have a process in place to collect information from a beneficiary, and should especially consider making contact with a beneficiary if the beneficiary's circumstances could change, like during the current pandemic.

The market volatility created by the pandemic also requires consideration by trustees. As the value of trust holdings rises and falls, trustees must consider whether continued holding of the trust's portfolio remains prudent.

In sum, it is impossible to tell what the future might bring under the best of times, and trying to tell the future is especially difficult now given the current political and economic environment. Trustees face real challenges when trying to account for potential future changes under these circumstances. Fortunately, the Act does not necessarily require a trustee to be right. A trustee can minimize the potential for liability by having a process in place to reasonably consider and document the trustee's decision-making process.

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