With a flick of the switch: Build an on-off mechanism into your estate plan

Published on December 17, 2020

When planning your estate, it's critical to balance estate tax planning and income tax planning. The rub is that, currently, strategies for reducing estate taxes generally focus on *removing* assets from your estate, while strategies for reducing income taxes generally focus on *including* assets in it.

Even if you have an estate plan in place that's tax-smart now, changes in tax law or your financial circumstances down the road could turn your plan on its head.   The good news is that you can build an "on-off switch" into your estate plan.

Estate tax liability vs. income tax liability

Generally, the best way to minimize estate taxes is to remove assets from your estate as early as possible (through outright gifts or gifts in trust) so that all future appreciation in value escapes estate tax. But these lifetime gifts can increase income taxes for the recipients of appreciated assets. That's because assets you transfer by gift retain your tax basis, potentially resulting in a significant capital gains tax bill should your beneficiaries sell them.

Assets held for life, on the other hand, receive a stepped-up basis equal to their fair market value on the date of death. This provides an income tax advantage because your beneficiaries can potentially sell the inherited assets with little or no capital gains tax liability.

Until relatively recently, estate planning strategies focused on minimizing estate taxes, with little regard for income taxes. Why? Because historically the highest marginal estate tax rate was significantly higher than the highest marginal income tax rate and the estate tax exemption amount was relatively small.

Today, the stakes have changed. The highest marginal estate and income tax rates aren't too different (40% and 37%, respectively). And, the gift and estate tax exemption is historically high ($11.58 million for 2020), meaning fewer taxpayers have needed to be concerned about estate taxes. However, this could change if proposals by President-elect Joe Biden come to fruition. They include reduced gift and estate tax exemptions, increased top rates for the estate tax and the individual income tax, and elimination of the step-up in basis.

Implementing the switch

With a carefully designed trust, you can remove assets from your estate while giving the trustee the ability to direct the assets back into it should that prove to be the better tax strategy in the future. There are different techniques for accomplishing this, but typically it involves establishing an irrevocable trust over which you retain no control and giving the trustee complete discretion over distributions.

If it becomes desirable to include the trust assets in your estate, the trustee can accomplish this by, for example, naming you as successor trustee or granting you a power of appointment over the trust assets.

Future-proof your estate plan

It's difficult to predict how your financial circumstances will change in the future and whether Congress will change the income or estate tax laws. Please contact us for additional details on how to add flexibility to your estate plan.

The Law Office of Eugene Gorrin, LLC
17 Watchung Avenue, Suite 204
Chatham, NJ 07928
973.701.9300
egorrin@gorrinlaw.com
www.gorrinlaw.com