Why it's important to plan for income taxes as part of your estate plan

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As a result of the current estate tax exemption amount ($11.58 million in 2020), many estates no longer need to be concerned with federal estate tax. Before 2011, a much smaller amount resulted in estate plans attempting to avoid it. Now, because many estates won't be subject to estate tax, more planning can be devoted to saving income taxes for your heirs.

While saving both income and transfer taxes has always been a goal of estate planning, it was more difficult to succeed at both when the estate and gift tax exemption level was much lower. Here are some strategies to consider.

Plan gifts that use the annual gift tax exclusion. One of the benefits of using the gift tax annual exclusion to make transfers during life is to save estate tax. This is because both the transferred assets and any post-transfer appreciation generated by those assets are removed from the donor's estate.

As mentioned, estate tax savings may not be an issue because of the large estate exemption amount. In addition, making an annual exclusion transfer of appreciated property carries a potential income tax cost because the recipient receives the donor's basis upon transfer. Accordingly, the recipient could face income tax, in the form of capital gains tax, on the sale of the gifted property in the future. If there's no concern that an estate will be subject to estate tax, even if the gifted property grows in value, then the decision to make a gift should be based on other factors.

For example, gifts may be made to help a relative buy a home or start a business. But a donor shouldn't gift appreciated property because of the capital gain that could be realized on a future sale by the recipient. If the appreciated property is held until the donor's death, under current law, the heir will get a step-up in basis that will wipe out the capital gain tax on any pre-death appreciation in the property's value.

Take spouses' estates into account. In the past, spouses often undertook complicated strategies to equalize their estates so that each could take advantage of the estate tax exemption amount. Generally, a two-trust plan was established to minimize estate tax. "Portability," or the ability to apply the decedent's unused exclusion amount to the surviving spouse's transfers during life and at death, became effective for estates of decedents dying after 2010. As long as the election is made, portability allows the surviving spouse to apply the unused portion of a decedent's applicable exclusion amount (the deceased spousal unused exclusion amount) as calculated in the year of the decedent's death. The portability election gives married couples more flexibility in deciding how to use their exclusion amounts.

Be aware that some estate exclusion or valuation discount strategies to avoid inclusion of property in an estate may no longer be worth pursuing. It may be better to have the property included in the estate or not qualify for valuation discounts so that the property receives a step-up in basis. For example, the special use valuation — the valuation of qualified real property used for farming or in a business on the basis of the property's actual use, rather than on its highest and best use — may not save enough, or any, estate tax to justify giving up the step-up in basis that would otherwise occur for the property.

Please contact us if you want to discuss these strategies and how they relate to your estate plan.

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