

Building Adaptive Trusts: Ensuring Tax Efficiency in an Evolving Tax Landscape

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The lifetime estate tax exemption amount is as high as ever. The estate tax exemption amount rose from \$1,000,000 in 2002 to \$5,000,000 in 2011. Then, Congress doubled the amount of the estate tax exemption in 2018. As of this writing, the current lifetime exemption amount is nearly \$14,000,000 per individual. With such high exemption amounts, there are few estates subject to federal estate tax.

The focus of estate planning has, therefore, shifted from removing assets from a decedent's estate to minimize or eliminate estate taxes, to ensuring that assets remain in the estate for estate tax purposes so that the assets receive a step-up in capital tax basis at the time of death. The "step-up" in the capital tax basis of assets means that for capital gains tax purposes, assets in a decedent's estate will reset to the fair market value of these assets at the time of their death. By way of illustration, if a stock were bought for \$100 and appreciated to \$1,000 at the time of the account holder's death, the beneficiary would only pay capital taxes on any further appreciation above \$1,000. If the beneficiary sold the stock for exactly \$1,000, no taxes would be owed. On the other hand, assets gifted during lifetime or held in an irrevocable trust do not receive a step up in capital tax basis.

With the ever-shifting tax landscape, the estate planner must carefully balance the likelihood that their client will have a taxable estate at the time of their death with the desire to include appreciated assets (especially assets with a low capital tax basis) in the Decedent's estate so that they will enjoy the step-up. But what happens if that calculation seems imprudent or unwise based on facts and circumstances in the future?

For example, suppose Peter wishes to provide all his assets to his wife, Mary. Peter's assets, when combined with Mary's assets, will be close to or exceed the lifetime estate tax exclusion amount. When Peter passes away, assets received by Mary will not generate any estate tax liability because spouses enjoy an unlimited marital tax deduction. However, it is possible that Mary may now have a taxable estate upon her death, especially if her assets continue to appreciate over her lifetime. Thus, the beneficiaries of Mary's estate will pay estate taxes on the assets they receive in excess of the lifetime exemption amount in effect at the time of Mary's death.

There are several ways to address these concerns and minimize or eliminate any estate taxes that may be owed in the future. Peter could remove some of his assets from his estate by establishing an irrevocable trust. This trust could be established either during his lifetime or via the use of testamentary trusts (i.e., a trust established at the time of Peter's death). However, Peter may want to avoid the costs and inconvenience of trust administration if it is possible that he and Mary will never have estate tax issues.

Another option is the "wait and see" approach using a "disclaimer trust" that may or may not be funded after Peter's death. Peter could direct in his will or revocable trust that his assets will pass outright to Mary. Mary may then make a qualified

disclaimer, effectively refusing to accept some or all of Peter's assets. Any disclaimed assets will bypass Mary's estate and go into the disclaimer trust, which can be used to support Mary for the remainder of her lifetime. The assets that pass to the disclaimer trust, and any subsequent appreciation in these assets, will remain outside of Mary's estate and will pass estate tax-free to her future beneficiaries.

Suppose after funding the disclaimer trust that Mary's assets are significantly spent down and exhausted during her lifetime. Perhaps a future Congress will increase the estate tax exclusion amount further or completely eliminate the estate tax. In any of these scenarios, the disclaimer trust will serve no tax purpose for Mary. Worse, the assets in the disclaimer trust will not receive the "step-up" in the capital tax basis at the time of Mary's death. Is there a way to unwind the disclaimer trust and ensure that these assets are includable in Mary's estate at the time of her death? With careful planning, the answer is "yes".

One powerful technique to resolve this issue is by appointing a trust protector for the disclaimer trust. A "trust protector" is a disinterested party with specific enumerated powers. The trust protector could be given the power to confer upon Mary a general power of appointment to choose any beneficiary she wishes to receive her estate assets, even her own estate. Pursuant to IRC § 2041, assets subject to a general power of appointment are includable in the power holder's estate for estate tax purposes. Now, whether Mary exercises her general power of appointment or not, the assets will be included in her taxable estate and receive a step-up in capital tax basis.

While this planning technique can provide significant tax benefits, it is not always the right choice in every situation. For instance, if Mary were to face creditor issues, granting her a general power of appointment would subject the entire disclaimer trust's assets to creditor claims. However, when implemented thoughtfully, incorporating a trust protector with the ability to grant a general power of appointment adds valuable flexibility, allowing the estate plan to adapt to the ever-evolving tax laws and optimize tax outcomes.