

## Steve Leimberg's Estate Planning Email Newsletter - Archive Message #3249

**Date:** 22-Oct-25

**From:** Steve Leimberg's Estate Planning Newsletter

**Subject:** **Martin M. Shenkman & Jonathan G. Blattmachr: What Can Taxpayers Cause Assets in Trusts They've Created to Be Included Back in Their Estates? And If They Can, Does that Make Sense?**

*"The new tax laws and the permanent high estate tax exemption may have changed the calculus of what should be done with respect to existing irrevocable trusts. But the wide range of factors affecting what might be done, and the many options (and variations of each option) that might be used to effectuate a desired plan, all make this analysis and process riskier and more complex. Remember the old adage 'measure twice, cut once.' Plan carefully before pulling the trust termination (or other steps) trigger."*

**Martin M. Shenkman** and **Jonathan G. Blattmachr** provide members with commentary that attempts to answer the following question: What can a taxpayer do to cause assets in trusts they've created to be included back in their gross estates? And if they can, does that make sense?

**Martin M. Shenkman** is an attorney in private practice in New Jersey and New York who concentrates on estate and closely held business planning, tax planning, and estate administration. He is the author of dozens of books and hundreds of articles and has won many professional awards.

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Here is their commentary:

### COMMENT:

#### Introduction

In 1921, the United States revenue or tax law was amended specifically to provide that the income tax basis (the value from which gain or loss is calculated) of inherited property to be equal to its fair market value at death. But the income tax basis of assets received other than by inheritance generally was not changed, and is not changed as a result of lifetime transfers to another taxpayer. Often, taxpayers have made lifetime gifts of assets to trusts or heirs directly to prevent estate tax imposed upon death. For many, that made and may continue to make, good sense in that, even though the assets that are no longer in the now

former owner's gross estate will not "enjoy" the income tax free step up in basis at death under Code Sec. 1014. (Section and Code Sec. each refers to a section of the Internal Revenue Code of 1986 as amended.) The top income tax rate of 37% (or 40.8%, with the net investment income tax (NIIT) imposed under Section 1411) is about the same as the Federal estate tax rate of 40%. So, the question arises as to whether such lifetime gifts make sense from a tax perspective.

For several reasons they do. First, almost all inherited assets are treated as long term capital gain property where the top rate usually is only 20% (or 23.8% with the NIIT). See section 1223(9). But typically, that lower rate can be obtained during lifetime as well as death. Second, not only is the tax on the property given away postponed until after death but income and gain earned on the assets after being given away may not be subject to estate tax when the owner dies.

But keeping assets out of an owner's gross estate means, in general, there will be no "step up" in basis when someone dies. On account of the very large estate tax exemption (\$15 million in 2026 and increased for inflation in later years), avoiding estate tax is not important for most people. In an "ideal" world, a taxpayer may wish to avoid estate tax even on amounts above the exemption amount and yet enjoy the stepped-up basis at death. What can be done to accomplish that?

### **Assets Given Away Prior to Death**

Just because assets are given away prior to death does not necessarily means they will not be in the gross (or tax inclusion) estate of the donor. Several provisions of the Code may cause assets given away prior to death to be included in gross estate of the donor. See, e.g., Sections 2035, 2036 and 2037. That is more likely to happen if the property has been given away in trust, so many advisors warn against making gifts in trust. For many reasons, including asset protection, that may not be the wisest course. Nonetheless, carefully structured, assets given away even prior to death can be excluded from the donor's gross estate even if in trust. And transferring the assets in trust prior to death may provide the best opportunity to reduce overall taxation: estate tax exclusion if the estate tax would be significant, or alternatively estate tax inclusion if the basis step up would result in lower aggregate tax even if some estate tax were due. And transferring property in trust likely provides that best opportunity to later decide which is preferable.

How might these two opposing options be preserved? One option is to make a completed gift to an irrevocable trust whose assets are outside the donor's estate. The trust, however, should be structured so that if desired the trust assets can later be included back in the donor's gross estate by terminating the trust and returning the assets to the donor. That may be simple to accomplish if the donor is a beneficiary of the trust. Usually, however, the donor will not be a trust beneficiary (unless the trust is a self-settled trust created in a jurisdiction permitting such trusts).

So, what other approaches can be used to try to cause the assets to be included in the donor's gross estate?

## **Circumstances to Evaluate and Weigh Before Terminating a Trust**

Before terminating an irrevocable trust, or taking other actions to endeavor to obtain a basis step-up for trust assets, consider any relevant factors that may influence the decision. These are broad and go well beyond just income tax considerations. Consider all the possible ramifications of any action you might take for an existing irrevocable trust.

- Appreciation in the trust currently. A critical initial question is how much appreciation is involved with the assets currently held in the irrevocable trust. Is it enough to warrant the analysis discussed below?
- What potential income tax cost might the trust assets realistically face? What is the potential income tax cost of a future sale of those assets on a present value basis. For example, the trust may hold an interest in a family business that is intended to be passed on to many future generations. In that case, the present value of an income tax cost of a sale that may never happen, or may only happen generations from now, may be very low or zero (although estate inclusion may increase the basis of assets providing for greater depreciation deductions, or smaller gain if the company or its assets are sold). There are also options for succession or exiting a family business that may minimize potential income tax costs such as using, depending on the facts, a charitable remainder trust (CRT) described in Section 664 to offset capital gains on the sale (assuming that the trust names a CRT as a beneficiary or has a mechanism to add a CRT as a beneficiary such as by a beneficiary who holds a special power of appointment which may be exercised in favor of a CRT), the exclusion permitted under Code Section 1202 for qualified small business stock, the family business equity may be exchanged for the acquiror's stock on a tax free basis, and so forth. For real estate might a Code Section 1031 like kind exchange that avoids current income tax be viable? It may not be prudent to undertake terminating or modifying an irrevocable trust without understanding whether or not the potential income tax costs would justify that. The decision process in some cases may be more nuanced than many people will initially realize.
- Appreciation that may be in the trust in the future. In some ways, this issue is really at the heart of the question. Regardless of what assets and appreciation may be inside the trust now, what is anticipated for the future? Might current assets be sold or traded for other assets in the future? For example, growth stocks may have been held in a particular irrevocable trust for many years and have appreciation but the primary beneficiary, perhaps a surviving spouse, may now be retired and need to access those assets. That may result in a planned liquidation of assets in the trust over his or her remaining lifetime. If that is the case, the trust itself may be viewed a wasting asset, analogous to a retirement plan, and the appreciation may not be anticipated to be present for the long term. If so, there may be no advantage to terminating the trust to include the assets in the surviving spouse's estate as that might only obtain a basis step up on the survivor's death if the surviving spouse dies prematurely.

- Tax law changes are a common occurrence. Under current tax law, there is a \$15 million permanent estate tax exemption. However, in the future there may be a shift in power in Washington and a Democratic Congress and White House may enact harsh and restrictive estate tax law changes including a much lower exemption. Carefully evaluate what happens if you terminate a trust to put assets back in a beneficiary's estate only to find that a future tax law change lowers the exemption and now those assets are subject to a substantial estate tax. Remember that the estate tax rate is 40% which is much higher than the capital gains tax. While the current high exemptions make the estate tax academic for most, that may not be the case in the future.
- Where will beneficiaries be receiving assets live? A similar scenario could arise if the beneficiary moves. For example, the beneficiary may live in a state (e.g., Florida) with no estate tax and move to a state with a state estate tax (e.g., Washington) that is decoupled from the federal system and a low estate tax exemption. That might result in the beneficiaries may be subjected to a state estate tax. Depending on the state estate tax and/or inheritance tax at the time of the beneficiary's death, much of the intended savings on capital gains could be erased or even exceeded by state estate taxes.
- What are the beneficiaries? risks of lawsuits, divorce or other claims? This may be the biggest threat to any plan to terminate an irrevocable trust (or distribute assets) to try to achieve a basis step up by having assets included in the estate of the beneficiary. This is the most litigious society in history, and nothing that occurs in Washington is unlikely to change that. We still have a high divorce rate. Incidences of elder financial abuse are growing exponentially. If you take assets out of the protective envelope of a spendthrift irrevocable trust and put them in a beneficiary's name for a basis step up, the threats to those assets can easily exceed the capital gains cost the taxpayer is trying to save. How can you even assess or measure these risks? Because somebody is older and retired may mean they no longer face malpractice or other claims from their business or professional practice (but consider how long the statute of limitations on suits may really be). But as a retired senior they may now face risks of elder abuse or medical costs that could be devastating. All this suggests that terminating a trust may not be wise.
- State laws may be relevant. Assume a trust was created in one state and is governed by the laws of that state but the beneficiary, such as the surviving spouse, has moved to another state. If you distribute assets out of the trust new state law may apply. This could be relevant to the ability of a new spouse of that beneficiary to reach those assets such as in a divorce or entitlement at death to some of them. So, one needs carefully to evaluate the legal implications of any transfer of assets out of a trust, or the termination of that trust.
- Family dynamics has to be considered. Family, however, defined, can be incredibly dysfunctional and combative. If assets are in a trust they should be distributed based on the terms of that trust. If assets are distributed out of the trust to a named

beneficiary for purposes of obtaining a basis step up, how will those assets ultimately be distributed? Certainly, the recipient beneficiary's will and revocable trust may govern distribution of assets but those documents can be changed and undermine the intended dispositive plan. How can that risk be assessed or controlled? So, for example, the dispositive provisions in a revocable trust could require the consent of a non-adverse party, such as the family advisor, before the provisions of the revocable trust are changed or the revocable trust is revoked. But will everyone involved take those extra steps? What if a family member, once they become aware that the assets are no longer in the protective structure of an irrevocable trust, tries to influence an elderly or infirm beneficiary that received those assets to make gifts to them regardless of what dispositive provisions are in the will and the revocable trust? Might the actions to get a basis step up just be inviting greater potential for family fighting and potential lawsuits?

- Are you certain the assets will receive a basis step up? The adjustment to tax basis on death is often called a "basis step-up" but that is not really correct. It's really a basis adjustment. The law provides that the cost basis of most assets the decedent owned at death is adjusted to the fair market value ("FMV") of those assets on the date of death. See section 1014(a). That adjustment is like the proverbial two-edged sword. If the value of assets declines, the tax basis is reduced, not increased. That could be an adverse tax result. If the trust assets are volatile, e.g., gold, small cap stocks, etc. what if the person the assets are distributed to dies when the market is down, any actions to move assets out of the trust may have an unfortunate tax result. Example: A trust owns stock purchased at \$1,000/share that is now valued at \$10,000/share. You pull the assets out of the trust and put them in the beneficiary's estate. The stock value of the stock declines to \$200/share. \$200/share becomes the tax basis of the stock if included in the beneficiary's gross estate. That is a step-down in tax basis not a step-up. After death the children as heirs continue to hold the stock and it appreciates back to \$1,000/share and they sell. Had the stock remained in the trust it would have retained its \$1,000/share cost basis. But now, because of the action pulling the stock out of the trust the basis is reduced and there will be a \$800/share capital gain that was avoidable.

### **Approaches To Address Lack of Basis Step-Up**

Once you have identified and evaluated the potentially relevant circumstances, consideration should be given to ways that might increase the basis of assets held in an irrevocable trust. As the adage goes: "There's more than one way to skin a cat." These may include:

- Modifying asset location decisions. Asset allocation refers to how your investment assets are divided between different asset classes. Asset location refers to which buckets those different assets are placed in. So, for example, you may hold certain assets in a Roth IRA, others in a regular IRA, others in an irrevocable grantor trust (that is, a trust the income, deductions and credits of which are attributed under Section 671 to the trust's grantor) and yet different types of assets in an irrevocable

trust. Which assets, even assuming a constant asset allocation overall, are located in which buckets can have a substantial impact on whether or not there is a benefit to modifying, terminating, or distributing assets from an existing trust. For example, when the estate tax exemption was only \$1 million, it may have been advisable to hold growth assets only in a so-called Credit Shelter Trust (not included in the gross estate of the surviving spouse) formed on the death of the first spouse. In that way, those assets would grow for the long term outside of the estate of the surviving spouse. But now, with a \$15 million permanent exemption there may be no concern about growing assets outside of the estate. So, in the current environment, if a Credit Shelter Trust exists it may suffice to solve the no basis step up issue by holding non-growth assets like bonds, or actively traded securities, in that irrevocable trust bucket. This approach is simple, may not involve any legal fees or additional documents, retains the protective structure of the irrevocable trust, etc. But it may change the value of what the family ultimately holds.

- If the particular trust involved is a grantor trust (a Credit Shelter Trust would not usually be one but see *Supercharged Credit Shelter Trust*<sup>sm</sup>, 21 Probate & Property (52 July/August 2007)), highly appreciated assets in the trust might be swapped for the trust's low basis ones which will now be into the grantor's estate and receive a stepped-up basis at death. (These might constitute borrowed funds, which will have a basis equal to their value and the debt incurred by the borrowing should be estate tax deductible under Code Sec. 2053.) And it has been contended that assets in a grantor trust have their basis changed when the grantor dies even if not included in the grantor's gross estate. See Gans & Blattmachr, 139 J. of Tax'n 16 (September 2023). Those assets may then achieve the desired basis step up. While cash is often used in such swaps, that is not the only answer. What if the settlor holds interests in a family business that is intended to be held for many future generations? For example, if the trust assets are comprised of appreciated marketable securities, but the family holds a family business that will be held long term, the assets in the trust can be swapped for the family business interests of equivalent value that the settlor of the trust holds. If the trust instrument does not include a right for the settlor to swap or substitute assets, but it is assuredly characterized as a grantor trust (the income, deductions and credit of which are attributed under Section 671 to the grantor) for income tax purposes, the trust could sell the stock to the grantor/settlor for the family business interests the settlor owns. No gain will be triggered on that transaction since transactions between the grantor and their grantor trust are disregarded for income tax purposes. See Rev. Rul. 85-13, 1985-1 CB 184. If the settlor does not hold the asset that is desired to be shifted into the grantor trust but rather a spouse owns it, the spouse can make a gift to the settlor who can then make the transfer. Obviously, reasonable time should be allowed to pass (and other steps be taken) before the swap or sale to avoid the implications of the step transaction doctrine. That could recharacterize the transfer as being from the spouse rather than the settlor. If the target asset that is desired to be in the trust is actually held by another family member it may be possible for that family member to simply make a gift to the grantor of the trust to effectuate the swap. With a \$15 million permanent estate, gift and GST, tax exemption the other family members may not be

concerned about using some of their gift and GST exemptions on such a transfer. So, when evaluating termination or other options whether or not the appreciation that may be of concern inside the trust can be readily shifted. It also should be kept in mind that spouses can sell or trade most assets between themselves without gain recognition under section 1041 which may eliminate any concern about timing.

- Distributing highly appreciated assets out of the trust can put them into a beneficiary
- s estate for step up purposes. Many trusts permit principal invasions, meaning the right of the trustee to make discretionary principal distributions to a beneficiary. You need to carefully review the provisions and the trust. If you're both the beneficiary and the trustee your rights to make distributions to yourself may be limited by what is called an ascertainable standard (health education maintenance and support, or ?HEMS?), so that the trust assets are not included in your estate. If that is the case, many trusts permit the ability to appoint an independent co-trustee and may permit that trustee to make discretionary distributions under a more ?liberal? standard than HEMS. So, if the trust instrument permits principal distributions or actions can be taken to obtain that flexibility, obtaining a basis step up on highly appreciated assets inside the trust may be no more than merely distributing that highly appreciated asset to a beneficiary. This approach, depending on the circumstances, may leave the trust intact with all of its protections and other benefits while just getting the most highly appreciated asset into an ownership where it can benefit from a basis step up. For example, a taxpayer creates an irrevocable trust in one of the approximately 20+ states that permit self-settled domestic asset protection trust (?DAPT?). A DAPT is an irrevocable trust a person creates for himself or herself and of which he or she is a beneficiary. Properly structured, that may remove the assets from the taxpayer's estate. The client lived in a state that does not permit DAPTs, then perhaps a trust protector of such a trust might be able to replace the existing institutional or corporate trustee to one in a more trust friendly jurisdiction (one that permits DAPTs) even if the client lives in a state without enabling legislation and that may alone cause estate inclusion under Rev. Rul. 76-103, 1976-1 CB 293. That could require little more than an action by a trust protector and may achieve the result sought. Be mindful that this may undermine any asset protection the trust would have afforded, and cause all assets in the trust to be pulled into the client's gross estate, not only the appreciated ones.
- Decanting to effectuate the desired change or set up the trust so that the desired change can be made after the decanting. Decanting is a process which may be permitted under state law (see, e.g., NY EPTL 10-10.6) and/or the trust instrument to merge the existing trust into a new trust. The decanting process generally cannot change who the beneficiaries are but can modify administrative provisions that could facilitate the desired objectives. For example, powers of appointment may be able to be added so long as not violative of the intent of the existing trust. Trustee powers may be expanded or clarified. Trust situs and governing law may be changed

and new state law may provide more flexibility (in fact the state to which the new trust will be moved could be selected because of more flexible laws). Distribution standards may be modernized, permitting more flexibility. And a power of appointment might be exercised to cause estate tax inclusion (and, also a step up in basis) by triggering the so-called "Delaware Tax Trap" under Section 2041(a)(3).

- Exercising powers of appointment may achieve estate tax inclusion and, therefore, a stepped-up basis goal. It is very common in many irrevocable trusts to grant certain person's powers of appointment. A power of appointment is a right to direct where trust assets will pass. In some instances, those powers are limited to only being able to be exercised following death of a name party. In other instances, powers of appointment may be permitted during lifetime. If a power of appointment is permitted during lifetime you may be able to have the power holder exercise that power in a manner that achieves the estate planning goal of a basis step up. See, e.g., Section 2041(a)(3). If the powers of appointment in the trust are insufficient to accomplish your intended goal, it may be feasible to decant the trust into a new trust that contains broader powers of appointment that can then be exercised.
- Other powerholder provisions may be in the existing trust. Depending on the design of the particular trust, there may be other persons, who could be identified by various names, including "trust protector," or even just "powerholder," who might be able to effectuate the change that is desired. For example, a Special Power of Appointment Trust ("SPAT"), described in detail in 46 Estate Planning 3 (Feb.2019), provides a named person, acting in a non-fiduciary capacity, to direct the trustee to pay assets to the settlor of the trust. That may resolve the issue of basis inclusion by simply giving a named powerholder the power to appointing those assets to the person desired, without causing a loss of creditor protection or triggering estate tax inclusion (until the assets are in fact appointed). See commentary to section 505 of the Uniform Trust Code and Rev. Rul. 76-103.
- Non-judicial modification agreements ("NJMA") may be used to modify the trust. This must be done under state law so that how much can be changed will depend on the latitude provided under state law. State law may permit broader change if the settlor who created the trust is alive and agrees to the changes. Typically, all beneficiaries and trustees must consent to the modification or at least do not object. In some circumstances, almost any change desired can be made. This can be done without court approval although the IRS (in an unofficial statement contained in ILM 202352018) has indicated unless the beneficiaries object to any change which could reduce their interests in the trust they may be deemed to have made a gift.

### **Consider Liability Risks of Modifying or Terminating a Trust**

Trustees engaging in any of the above techniques should evaluate the potential implications and what if any liability exposure the proposed steps may trigger. Consider the following example:



Father died and his estate passed to a Credit Shelter Trust to benefit his surviving wife and on her death the children. He named his brother as trustee and gave him broad authority to distribute any principal to his wife/beneficiary in the trustee's sole discretion. The assets in the trust are highly appreciated so the brother distributes them to the wife as permitted under the trust. The assets will be included in her estate and be subject to a basis adjustment (hopefully a step up) on her death. Consider the view of the beneficiaries if assets in an old Credit Shelter Trust are distributed to their surviving parent as a beneficiary to gain a step up in tax basis on her death. If shortly after the distribution the surviving widow remarries and bequeaths the assets to her new husband, how will the children feel? They will have achieved the desired step-up in income tax basis but lost their inheritance. Instead, giving the surviving spouse a special power of appointment so that spouse could trigger the Delaware Tax Trap, without passing assets to persons not originally named as beneficiaries might be a better result.

What about the liability exposure of advisers who may have cavalierly recommended the plan? Will having the children sign off approving the plan suffice to insulate the trustee and advisers from liability? Maybe. But if the attorney for the wife handled the planning and transaction, who represented the beneficiaries? If they did not have legal counsel, might they argue in their suit against the trustee and advisers that they were misled? Caution is in order.

### **Make A Trust Action Plan**

Consider having the advisors to the family prepare a memorandum summarizing all relevant facts and options so everyone understands what is involved. That doesn't substitute for recommending that each retain their own legal adviser.

Tailored actions may be best, e.g. dividing a trust and taking different actions as to each part may get a better result. For example, divide the trust and put the most appreciated assets in one trust and all other assets in the other. Take the actions to address basis step-up only with respect to the new trust that has the appreciated assets. Perhaps, the other trust is left intact.

In some cases, the simplest approach of just changing asset location decisions, or distributing some of the highest appreciated assets, may be all that is required.

In some, perhaps many cases, when all the risks and implications are objectively evaluated, staying the course with no restructuring or termination may be the preferable approach.

### **Conclusion**

The new tax laws and the permanent high estate tax exemption may have changed the calculus of what should be done with respect to existing irrevocable trusts. But the wide range of factors affecting what might be done, and the many options (and variations of each option) that might be used to effectuate a desired plan, all make this analysis and

process riskier and more complex. Remember the old adage "measure twice, cut once." Plan carefully before pulling the trust termination (or other steps) trigger.

**HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!**

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**CITATIONS:**

Sections 664, 1014(a), 1031, 1041, 1411, 2035, 2036, 2037, 2041(a)(3) of the Internal Revenue Code of 1986 as amended; O'Connor et al, "Special Power of Appointment Trust," 46 Estate Planning 3 (Feb.2019); Gans & Blattmachr, "Rev Rul 2023-2," JI of Tax'n: Gans, Blattmachr & Zeydel, "Supercharged Credit Shelter Trust<sup>SM</sup>," 21 Probate & Property (52 July/ August 2007);; EPTL 10-10.6; Rev. Rul. 76-103, c1976-1 CB 293; Rev. Rul. 85-13, 1985-1 CB 184.