Ties, Taxes, and the Future of Estate Planning

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A UNEXPECTED OPPORTUNITY

DEMOCRATIC CONTROL OF CONGRESS AND THE PRESIDENCY

- Election of Joe Biden, a “tie” in the Senate, and a majority in the House
- Covid, economic woes, wealth concentration and the looming deficit
- Biden Campaign Platform and Promises

FIVE THINGS TO DISCUSS

- Where we are now
  - Current Tax Law
- Where are we going?
  - President Biden's Tax Proposals
  - Other Potential Changes
- How will we get "there"?
  - Budget Reconciliation
- What will it look like?
  - Current Uncertainty
  - Effect on current estate planning tools
- What to do now?
  - Advise affected clients of risks and options
  - Options for gifting as appropriate
  - How to talk to our clients

CURRENT LAW

2017 TAX CUTS AND JOBS ACT

- Achieved via Budget Reconciliation
- Numerous Significant Changes
  - Corporate Income Tax rate reduced from 35% to 21%.
  - Creation of § 199A Qualified Business Deduction.
  - Doubling of Estate Tax exemption.
  - Reduced Rates for Individual Income Tax Brackets.
  - Increased Standard Deduction while eliminating Personal Exemption.
  - Elimination/reduction of many long-time deductions.
- Many Changes Temporary
  - To comply with Budget Reconciliation Rules many changes “sunset” on January 1, 2026.
  - Notably the Corporate Income Tax rate does not sunset.
- Significant Tax Cut for High Earners and Businesses
- Significant Cost
  - Trump Administration predicted tax cuts and budget would boost revenue to offset losses from tax cuts.
  - Joint Committee on Taxation initially predicted a $1.5 Trillion deficit increase over ten years, later updated to first $1.9 Trillion and more recently $2.3 Trillion, partially offset by a boost in economic activity of $385 Billion.

CURRENT LAW

INCOME TAX

- Individual
  - Seven Brackets: 10%, 12%, 22%, 24%, 32%, 35% and 37%
  - Top Rate Threshold: $523,600 single / $628,300 MFJ
  - Standard Deduction: $12,550 / $25,100
  - Limited State and Local Tax Deduction: $10,000
  - Capital Gains: 15% and 20%
  - Pass-through Entities: 20% deduction for “Qualified Business Income”, deduction limited for “specific service trade or business”
  - Net Investment Income Tax: 3.8% of lesser of (a) taxpayer’s net investment income or (b) the amount their modified adjusted gross income exceeds $200,000 ($250,000 married filing jointly)

CURRENT LAW

ESTATE, GIFT, GENERATION SKIPPING TRANSFER TAXES

- Estate Tax
  - Rate: 40%
  - Exemption: $11.7 Million (during life + at death, portable)
  - Capital Assets: Basis “step-up” at Death eliminates gain
- Gift Tax
  - Rate: 40%
  - Exemption: $11.7 Million (during life + at death, portable)
- Generation Skipping Transfer Tax
  - Rate: 40%
  - Exemption: $11.7 Million

CURRENT LAW

OTHER NOTABLE TAXES AND PROVISIONS

- Corporate Income Tax
  - Rate: 21%
- Social Security
  - Rate: 12.4% payroll tax, split between employers and employees
  - Phase Out: $137,700

OTHER FACTORS

COVID-19

- CARES, HEROES and the CAA
  - Temporary Provisions: Recovery rebates, subsidies and grants to business owners, various tax credits, etc.
  - Permanent Provisions: The CAA has made certain temporary provisions permanent.
- FUTURE LEGISLATION
  - Aid to individuals, small businesses, and the States: President-elect Biden and Democratic leaders have indicated their intention to pass additional legislation.

WHERE ARE WE GOING

INDIVIDUAL INCOME TAX

- Tax Increases on Income over $400,000
  - Restore 39.6% Top Rate
  - Expand Social Security Tax: 12.4% of earned income over $400,000 split between employer and employee.
  - Itemized Deduction Tax Benefit Limited to 28%
  - Restore the 3% PEASE limitation: Reduces itemized deductions by 3% of AGI over $400,000.
  - Add phaseout to 199A: would reduce application of 20% deduction for "Qualified Business Income" for non-SSTB.

WHERE ARE WE GOING

INDIVIDUAL INCOME TAX

- Other Changes
  - 39.6% Rate for Capital Gains over $1 Million.
  - Increase Child and Dependent Care Tax Credit.
  - Expand EITC for childless workers aged 65+.
  - Reestablish first time home buyers tax credit.
  - Return of SALT deduction(Pelosi, Schumer)?
  - Mark-to-Market for capital assets (Wyden)?

WHERE ARE WE GOING

ESTATE AND GIFT TAX

- Restore 2009 levels
  - $3.5 Million Estate Tax Exemption, unindexed but portable
  - $1 Million Gift Tax Exemption, unindexed but portable
  - 45% Rate

- Eliminate Basis Step-Up
  - Unclear how this would work
  - Carry-over Basis vs. Unrealized Appreciation taxed at death

- Return of the § 2704 Proposed Regulations
  - IRS published proposed regulations in 2016 limiting valuation discounts for closely held businesses
  - Withdrawn due to President Trump's Executive Order limiting new regulations
  - Was a priority of the Obama Administration
  - Would be easy to republish

WHERE ARE WE GOING

OTHER PROPOSED TAX CHANGES

- Corporate Income Tax
  - Increase rate to 28%.
  - Create a minimum tax on corporations with book profits of $100 Million.
  - Double rate on Global Intangible Low Tax Income (GILTI) earned by foreign subsidiaries.
- Miscellaneous
  - Completely eliminate § 1031 (Like-Kind Exchanges).
  - Create Renter's Tax Credit aimed at holding rent and utilities at 30% of monthly income.
  - Create and expand several renewable energy/green tax related credits.
  - Eliminate subsidies for fossil fuels.
  - Student Loan Debt Forgiveness.
- For the 99.8% Act – Bernie Sanders' annual tax proposal
  - Quadruple the special use valuation cap to protect family farms and businesses.
  - Value non-business assets held in entities as if owned outright.
  - Require GRAT terms of at least 10 years and remainders of at least 25% of assets transferred to GRAT.
  - Treat grantor trusts as owned by grantor for gift and estate tax purposes (distributions from trust = gifts by grantor; include trust assets in grantor's estate).
  - Deny allocations of GST exemption to trusts that may last longer than 50 years.

HOW ARE WE GOING TO GET "THERE"

BUDGET RECONCILIATION

- Democrats don't have filibuster-proof 60 votes in the Senate.
- Can use Budget Reconciliation instead, requires 51 votes for spending, tax and debt limit bills.
- Democrats have 50 votes, Vice President Harris will cast a vote if there is a tie.
- Budget Reconciliation used to pass 2017 Tax Cuts and Jobs Act to avoid filibuster, also used to pass 2001 Tax Act with Vice President Cheney casting deciding vote in the Senate.
- Budget Reconciliation process:
  1. House and Senate must pass concurrent Budget Resolution with instructions to committees to change spending or revenue amounts.
  2. Must then pass reconciliation bills that adhere to the instructions.
- Two opportunities for reconciliation in 2021
  - Currently for 2021 fiscal year budget: Within first 100 days of new administration, likely to be used for additional COVID related legislation.
  - 2022 budget: Usually passed in Spring, reconciled in Fall.

LIMITS ON BUDGET RECONCILIATION

BYRD RULE

- Prohibits extraneous matters from budget reconciliation bills and requires 60 votes in the Senate to waive. Applies to provisions that:
  - Do not create a change in spending or revenue.
  - Create changes in spending or revenue that are merely incidental to non-budgetary elements of the provision.
  - Are outside the jurisdiction of the committee that submitted the provision for inclusion in the reconciliation measure.
  - Increase spending or reduce revenue if overall the provision does not meet the instructions given to the reporting committee.
  - Increase net spending or reduce revenue during a fiscal year after the years covered by the reconciliation bill unless the provision as a whole remains budget neutral.
  - Contains recommendations regarding Social Security trust funds.
- Consequence of limitations
  - Need to create "sunset" to avoid provisions that worsen the financial position of the government beyond the 5 or 10 year period covered by the bill – see both the Tax Act of 2001 and the Tax Cuts and Jobs Act of 2017.
  - Remember, the Affordable Care Act could not be completely repealed via Reconciliation.

LIMITS ON BUDGET RECONCILIATION

POTENTIAL EXAMPLES

- Many high profile Democratic proposals cannot be enacted using Budget Reconciliation:
  - Minimum wage legislation
  - Changes to the Voting Rights Act
  - DC or Puerto Rico Statehood
  - Gerrymandering reform
- But Budget Reconciliation could be used for proposals that may not be obvious:
  - Paid parental and sick leave
  - Housing vouchers
  - Clean energy investment
  - Expanded health care coverage
  - Free community college
  - Child allowance

EFFECTIVE DATE

RETROACTIVE CHANGES

- Tax legislation, even through budget reconciliation, may be effective immediately, at a point in the future or even retroactively:
  - The U.S. Supreme Court has repeatedly upheld retroactive tax legislation against due process challenges.
  - The standard is the law must be rationally related to a legitimate legislative purpose.
  - See *Pension Benefit Guaranty Corporation v. R.A. Gray & Co., 467 U.S.* 717 (1984); *U.S. v. Carlton*, 512 U.S. 26 (1994).
- Consequences/Complications of retroactivity
  - Changes to taxation of prior gifts.
  - How to deal with a completed § 1031 exchange where now no longer tax-deferred.

EXEMPTION REDUCTION CONSEQUENCES

- IRS guidance clarifying no “clawback” if gift at higher exemption then die with lower exemption.
- However, IRS and industry guidance indicate that the amount of exemption when a taxpayer dies will likely first be applied to prior lifetime gifting. So if made gifts of $5 Million in 2020, and die in year when exemption is $3.5 Million, we apply the $3.5 Million to the prior gifting and “use it up”, there’s no clawback for the $1.5 Million difference, every dollar in the taxpayer’s estate will be subject to estate tax and the taxpayer will have “lost” use of $6.4 Million of exemption.

WHAT WILL THE FUTURE LOOK LIKE

MUCH UNCERTAINTY STILL

- Clear Democratic consensus to increase income tax on highest earners and expand Estate Tax, unclear what form this will take
- What about the Gift Tax? What about GST Tax?
- Proposed §2704 Treasury Regulations
- What about basis?

EFFECT ON COMMON ESTATE PLANNING TOOLS

- Intentionally Defective Grantor Trusts
  - Grantor trust for income tax purposes, not in estate for federal Estate Tax
  - If pay tax on unrealized gains at death, does IDGT avoid the tax?
  - What if Bernie Sanders' grantor trust treatment proposal is adopted?
- Bypass Trust Formulas
  - Change in exemption may lead to unanticipated consequences
  - Funding language issues: "largest amount that can pass free of federal estate tax," will a capital gains tax at death be an "estate tax"? What if the term is "death tax"?
- Disclaimer Clauses
  - Absolutely necessary for current gifting
  - Provides 9 months to determine what amount may be used to fund credit trust or equivalent

WHAT TO DO NOW

DEPENDS ON CLIENT'S SITUATION

- Use it or Lose it vs. concern of giving too much away
  - Need to make sure client is comfortable
  - Need to be deliberate and realistic in making recommendations: "First, do no harm"

- Practitioners should be cautious dealing with clients who will potentially lose exemption
  - Model/forecast planning scenarios
  - Apprise client of risks
  - Offer options
  - Have lien, judgment, credit report and any other due diligence completed
  - Have client execute letter affirming understanding of risks whether client decides to plan or not
  - Build in flexibility

- Estate Plan in place
  - Review current plan
  - Options for modifying

WHAT TO DO NOW

SOME OPTIONS/PROVISIONS WHERE CURRENT GIFTING APPROPRIATE

- Use of Disclaimers
  - Include a disclaimer provision in all irrevocable trusts used for 2021 gifting.
  - If multiple beneficiaries consider empowering one to disclaim on behalf of all.
  - Gives 9 month window under § 2518 to disclaim resulting in exemption not being used.

- QTIP Trusts
  - Make transfers to trust that will qualify for the marital deduction if a QTIP election is made on a gift tax return by 2021 extended filing date (October 15, 2022).
  - Any amount not elected will pass to non-qualifying trust for spouse that would use the exemption.

- Formula Gifts
  - Make gifts to a trust of a fractional share of assets.
  - Numerator is "my available exemption".
  - Denominator is the full value of the asset as finally determined for gift tax purposes pursuant to § 2505 and any retroactive changes to such provision.
  - Put assets in LLC and transfer fractional interest of LLC if appropriate.
  - Based on *Wandry* case; must include notice with Form 709 that formula clause was used.
  - Can have a backup where give any amount in excess to spouse.
  - Still include disclaimer.

WHAT TO DO NOW

SOME OPTIONS/PROVISIONS WHERE CURRENT GIFTING APPROPRIATE

- Gifting in General
  - For couples with significant wealth, consider only one spouse make significant gifts (don’t gift split).
  - Non-gifting spouse retains “new” exemptions, and portability may still be available.
  - Direct gifts of cash vs. assets with built-in gains.
  - Utilize discounting while still available (§ 2704 Regulations).
- SLATS
  - Spousal Lifetime Access Trusts
  - Spouses create a trust for each other but need to avoid Reciprocal Trust Doctrine.
  - Create different distribution schemes, include different beneficiaries, create at different times, etc.
  - Community property issues – need to convert to separate property, may be difficult to overcome the Reciprocal Trust Doctrine.
  - Potential elimination of basis step-up also eliminates reason not to use SLATs (two step-ups in community property states).
  - Include a disclaimer provision.
- Domestic Asset Protection Trusts
  - Make sure gifts to trust completed to exclude from grantor’s estate.
  - Need to confirm no outstanding creditor issues.
  - Usually set up in Alaska, South Dakota, etc. (19 states allow now) but beware, Washington law regarding creditor claims may still apply, (*In re Huber*).
  - Should not be used if there is any concern regarding creditors or need for immediate distributions (want to prohibit distributions for 10 years + 1 day to avoid § 548(e) of the Bankruptcy code).
- Special Power of Appointment Trusts (SPATs)
  - Irrevocable trust with family as beneficiaries.
  - Trustee has no power to distribute to/for the benefit of grantor.
  - Non-beneficiary individuals named and granted lifetime special powers of appointment that can be exercised in favor of grantor or other family members.

UPDATING ESTATE PLANS

OPTIONS FOR MODIFYING PLANS

- Some items may not be affected/able to be changed
  - Installment Note Sales
  - GRATs
- New documents
  - Amending & Restating Trusts
  - Wills
  - Powers of Attorney
- Modifying Irrevocable Trusts
  - Authority of Trustee or Trust Protector
  - TEDRA
- Lack of capacity
  - Power of Attorney
  - TEDRA

WHAT TO TELL OUR CLIENTS

- Education
  - Need to review their net worth, assets and plan
  - How new laws may affect their plan and potential tax implications
  - Options for using current exemption and provisions designed to avoid making a current taxable gift in excess of exemption
  - Taxes not only reason to plan:
    - Asset protection
    - Control over assets
    - Family dynamics
    - Potential protection against elder financial abuse

QUESTIONS AND COMMENTS?

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