A Closer Look

Low Rates, High Hopes, and (Maybe) Higher Taxes: Estate Planning for 2021 and Beyond

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In Brief

- **President-elect Biden has indicated his desire to make major federal tax law changes, including changes to laws impacting estate planning.**
- **Of course, any changes in tax law require congressional legislation, and at this point, we don't know when such a bill will be introduced, how the provisions will line up with campaign rhetoric, if it will be successfully passed, and if so, when it would take effect.**
- **In an environment of low rates, market volatility, and uncertainty regarding future tax laws, several potentially useful estate planning opportunities present themselves. In this A Closer Look, we explore some of the techniques we are discussing with our clients right now.**

The end of 2020 will mark the close of a uniquely challenging year for all of us — on virtually all fronts. While hopeful trends are emerging, significant uncertainty persists in many areas.

Regarding estate planning in particular, we find ourselves with a president-elect looking to make major changes to federal tax law, including changes to the estate, gift, and generation-skipping transfer tax (GSTT) laws. Of course, we don't know when these changes will actually be proposed in Congress. And we don't know with certainty what the proposed changes will be. After all, campaign rhetoric tends to change when translated into actual legislation, and the legislative process itself has a way of transforming proposals even further on their journey to becoming law — that is, if the bill manages to pass at all. The results of the upcoming Georgia runoff elections — and whether the Republicans retain control of the Senate — will help determine the likelihood of any major tax laws passing.

Even assuming a tax bill is eventually introduced and enacted, it's not clear when the changes would take effect. Right now, our best thinking is that estate taxes are not the highest priority of the Biden administration and thus may not be considered until mid to late 2021. If so, it is highly likely (but not guaranteed) that they would be effective upon enactment or some date after enactment. But it's also possible that the changes would be retroactive to the beginning of 2021. When retroactive tax legislation is passed, it is more likely related to income taxes, not transfer taxes. After all, there is an inherent unfairness to converting a gift that was tax-free when made into a taxable gift by retroactively changing the gift tax exemption.

What does all of this mean for your estate plan, and what, if anything, should you be doing about it?

In an environment of low rates, market volatility, and uncertainty regarding future tax laws, several potentially useful estate planning opportunities present themselves. In the following sections, we explore some of the techniques we are discussing with our clients right now. One or more of them may be a good fit for you and your family.

What Should Be Done: Full Use of Gift and GSTT Exemptions

The current tax law permits a very favorable $10,000,000 exemption each for gift/estate tax and generation-skipping transfer tax purposes. These values are indexed for inflation and, in 2021, will be $11,700,000 each.

The law that doubled the exemption to $10,000,000 is scheduled to sunset December 31, 2025. Thus, absent a law change, as of January 1, 2026, the exemptions will be $5,000,000, indexed (likely to be around $6,500,000).

We encourage clients to consider whether they should use the enhanced amount before 2026. Many clients, concerned about possible November 2020 election results, opted to do so in 2020. While campaigning, President-elect Biden quietly expressed an interest in reducing the exemption as well as increasing the transfer tax rate (currently 40%). Regardless, lifetime gifts have potential advantages over inheritances at death. Thus, for those clients who have exemption remaining and are considering making use of it before the exemptions are scheduled to sunset, 2021 may be a good year to implement this planning.

Because of the way the exemption is utilized, one must give more than what the exemptions revert to in order to capture the temporary increase. This is because the IRS has told us that lifetime gifts use the base basic exclusion amount first (pre-2017 $5 million, indexed), and the enhanced amount second (the temporary additional $5 million, also indexed). In other words, the ordering is that gifts come "off the bottom," not "off the top."

The maximum benefit would be derived by giving away the entire $11,700,000 (the indexed exemption for 2021), or for a married couple, a combined $23,400,000. That said, we recognize that this is a tremendous sum of wealth, and only a few of even the wealthiest families can afford to give away such an amount without impacting their lifestyles.

How Exemptions Are Scheduled to Work Post Sunset

Assuming no changes to current tax law, starting January 1, 2026, each person's basic exemption will be $5 million, indexed, minus all prior taxable gifts. (It should be noted that President-elect Biden's tax proposal might seek to decrease exemptions even further to $3.5 million per person.) Let us assume that the indexed amount will be $6.5 million.

- If you previously gave away $6.5 million, you would have $0 remaining. Unfortunately, you would not have used any of the enhanced amount.
- If you previously gave away $11,000,000, you also would have $0 remaining.
  - You would have used the enhanced amount to the extent your gifts exceeded the new basic amount ($11,000,000 – $6,500,000 = $4,500,000).
  - This $4,500,000 of wealth transferred was an opportunistic use of the enhanced exemption — you moved those assets, and their future growth and income, outside of your taxable estate.

Naturally, clients ask whether one can give assets away and retain access to them, or at least to the income they produce. Unfortunately, the IRS will treat assets given away as part of the donor's estate if they retain benefits from the transferred wealth. So, many estate planning discussions explore techniques to get as close as possible to providing access, without going too far. One popular approach is to transfer the gift into an irrevocable trust for the benefit of the donor's spouse and others, typically children. By including the spouse as a potential beneficiary, the trustee is empowered with discretion to distribute assets to the beneficiary spouse. While this does not flow the assets back to the funding spouse, benefits can be realized by distributions to the beneficiary spouse, who can use the funds for any purpose, including their joint lifestyles. Because these trusts provide access to one's spouse, they are often referred to as Spousal Lifetime Access Trusts, or SLATs (for more information, see "Is Now the Time to Consider a Spousal Lifetime Access Trust?").

Biden's Tax Plan

Among President-elect Biden's many potential tax proposals are several with implications for wealth transfer planning:

- **Reduce the gift, estate, and generation-skipping transfer tax exemptions.** In 2021, you will be able to transfer up to $11,700,000 ($23,400,000 per married couple) during life or at death free of incurring federal gift or estate tax. Biden has proposed a return to the previous lower level of $3,500,000 ($7,000,000 per married couple). He has also expressed his desire to limit the duration of the generation-skipping transfer tax exemption.
- **Raise the gift and estate tax rate.** Biden has proposed raising the top gift and estate tax rate from 40% to 45%.
- **Eliminate basis step-up at death.** Right now, for federal income tax purposes, basis of inherited property is adjusted to date of death fair market value. Often referred to as a "step-up," this eliminates capital gains tax on all appreciation prior to the decedent's death. Biden has proposed eliminating the step-up in basis at death.
- **Increase the tax rate on long-term capital gains and qualified dividends.** Today, the maximum federal tax rate on long-term capital gains and qualified dividends is 20%. Biden has proposed an increase to 39.6% for high-income earners. The 3.8% Medicare surtax would continue to apply.

For 2021, each person will also have a similarly temporarily doubled $11,700,000 of generation-skipping transfer tax exemption available during lifetime and at death. The benefits of using this exemption are that, once assets are favored by allocation of the exemption, they are not subject to the additional generation-skipping tax if given to someone two or more generations younger. More impactful is the fact that, when the assets are funded into a trust and the exemption is allocated, they are not included in any beneficiary's estate for as long as they remain in the trust. How long they remain in trust is a function of a beneficiary's need and state law. In Florida, for example, this can last for 360 years, or about 15 generations. The compounding effect of avoiding a 40% (or greater) estate tax for 15 generations is significant. Other states vary — some shorter, others longer (even in perpetuity). While campaigning, President-elect Biden indicated a desire to limit the duration of the effectiveness of an allocation of generation-skipping transfer tax exemption.

How Gifts Should Be Made: Grantor Trusts

No one wants to pay more taxes than required, but paying the tax on money set aside for your heirs is a powerful wealth-shifting technique. The most common planning technique to accomplish this shift of income liability is the use of a trust specially designed to treat the grantor as the taxpayer.

The result is that the wealthy family member who funded the trust uses retained wealth to pay the income tax on earnings of the assets inside the trust. Why does this help? First, the retained wealth likely would be subject to estate tax at the wealthy person's death, so the taxable estate will be reduced (meaning that the income tax was paid with discounted assets); and second, the trust retains 100% of the earnings without diminishment for income tax, bulking up the value inside the trust — which is outside of the grantor's estate. Although one can easily see how the beneficiaries are benefited by the use of a grantor-style trust, the IRS has ruled that the payment of the taxes is not a taxable gift.

Because there is no income tax on events between the grantor of a grantor trust and the grantor trust, additional planning can be implemented with grantor trusts. It can be an effective vehicle for lifetime gifts, and it can be further used for other techniques and inheritances at death, as we discuss in the following section.

What Assets Should Be Used: Basis Planning

Basis is the term used to describe one's investment in an asset. Generally, when that asset is sold, capital gains are determined by subtracting basis from the sale price. There is a major difference in the treatment of basis for gifts during life versus bequests at death.

When an asset is given to another person, the recipient is treated as having basis equal to the donor's basis. This is known as carryover basis. There are some adjustments, such as an increase for any gift taxes paid on the transfer, but these are rare.

In contrast, under current law, there is an adjustment of basis at the death of the owner if included in the owner's taxable estate (even if no estate tax is due).

In this circumstance, the recipient heir is treated not as having carryover basis, but as having an adjusted basis. The adjusted basis is equal to the fair market value of the asset at the date of death (or alternate valuation date, if used). This is typically referred to as a "step-up" in basis, though tax advisors are quick to point out that this rule also can result in a "step-down."

So a thorough analysis of basis should be undertaken when considering making a gift. This analysis includes whether the donor is likely to sell or retain the asset until death, and whether the donee also is likely to sell or retain the asset for an extended period of time.

An interesting feature of grantor trusts, discussed above, is that assets may be exchanged with such trusts tax free. Given market volatility or other changes, it makes sense to review the assets in one's name as well as those in one's grantor trust to determine whether those with higher growth potential or equal potential but higher basis should be swapped into the trust in exchange for lower-returning or lower-basis assets. The return of lower-basis assets positions them for basis adjustment at the grantor's death.

It should be noted that, while campaigning, President-elect Biden announced a goal of eliminating basis adjustment at death. While the announcement lacked much detail, it is something to look out for in any new legislative proposals.

Other Techniques to Consider

Clients should generally use as much of the enhanced exemption as makes financial sense, but that is not the only estate tax planning technique clients should consider in 2021. Below are three additional techniques favored in the current tax law and economic environment (for more detail on each of these techniques, see "Strategic Estate Planning Opportunities During Market Volatility"):

- **Low interest rate loans.** The minimum (applicable federal rate, or AFR) interest rates remain at historic or near-historic lows, creating opportunities, especially within families and trusts for loved ones.
- **Grantor retained annuity trusts (GRATs).** Strong market shifts can generate significant wealth transfer results for GRATs structured and managed to capture volatility. While we typically recommend two-year term GRATs for marketable securities, we note that, while campaigning, President-elect Biden indicated that he would like to modify the rules applicable to GRATS, which would render them an unlikely technique for most.
- **Zeroed-out charitable lead annuity trusts (CLATs).** In a charitable lead trust (CLT), the lead interest is paid to a charity, with the remainder reverting back to a family member or friend. The low interest rate environment can enhance the results for a zeroed-out annuity form of CLT, known as a CLAT.

Conclusion

At this point, we do not know what changes, if any, will be made to the estate, gift, or generation-skipping transfer tax laws in 2021. But the fact is that uncertainty with regard to taxes is nothing new — tax laws are always subject to revision — and making large, impulsive alterations to your estate plan based solely on possible tax law changes is rarely an effective strategy. Rather, it can help to think of your estate planning as a process that occurs with careful deliberation over time, anticipating and adapting thoughtfully to changing tax laws and your evolving priorities — because minimizing taxes, while important, is only one of the many goals of that process. The current environment does present us with a number of planning opportunities, and it's probably a good time to consult with your family and advisors to review your priorities. As always, Bessemer's estate planning specialists remain available to speak with you about which planning techniques could make good sense for you.

We wish everyone the best of health and look forward to working with you in 2021.

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