

Tax, Benefits, and Private Client



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Estate Planning in 2021 and Beyond: The Possible Impact of Democratic Control in Washington

The Democrats now have effective control over the presidency, the Senate, and the House, at least until the 2022 mid-term elections. These political realities, along with current economic conditions, make it more likely that significant changes to the existing income, gift, and estate tax regimes are imminent, if not this year, then at least before the end of 2022. The possibility of these changes makes 2021 an opportune time to review and potentially implement estate planning strategies, which could save your family millions of dollars of taxes.

WHO SHOULD BE INTERESTED IN THESE CHANGES?

Ultra-High-Net-Worth Clients: In anticipation of tax law changes post 2020, many ultra-high-net-worth clients (estates in excess of \$23 million for a married couple, or in excess of \$11.5 million for an individual) took steps last year to remove millions of dollars out of their estates, thereby reducing their families' ultimate estate tax burden. **There are many ultra-high-net-worth clients who either did not implement gift planning last year or did not fully utilize their available gift and estate tax exemptions and can still do so in 2021.**

High-Net-Worth Clients: In general, most high-net-worth clients (estates in excess of \$7 million but less than \$23 million for a married couple or in excess of \$3.5 million but less than \$11.5 million for an individual) did not implement significant gift planning last year because it was thought that the potential tax law changes would not immediately apply to them. **The results of the 2020 election make it more likely than ever that High-Net Worth Clients will be impacted by the potential changes.**

WHAT MAY CHANGE?

Whenever there is a political and/or economic environment that is considered ripe for tax increases, tax professionals look to changes proposed but not enacted in the past that can easily be "pulled off the shelf" when needed. Past proposals that, if enacted, could have a significant impact on estate planning include the following:

Reduced Transfer Tax Exemptions: Under current law, the federal gift, estate, and generation-skipping transfer ("GST") tax exemption amount for 2021 is \$11.7 million

per individual or \$23.4 million for a married couple and increase by inflation each year, **but only until January 1, 2026, when the exemption amounts will automatically be reduced effectively by 50 percent.** The Biden campaign proposed an immediate reduction in the estate and GST tax exemptions to \$3.5 million per individual or \$7 million for a married couple **and a reduction of the lifetime gift tax exemption to only \$1 million per individual or \$2 million for a married couple.**

These changes could legally be made retroactive to January 1, 2021, though most tax professionals believe that any such changes will be made prospectively—either effective at a later date (for example, later in 2021 or perhaps on January 1, 2022), or when the change is first publicly introduced in Congress. If the changes are not made by the end of 2022, it is likely, given the general political climate, that the automatic reduction will take place as scheduled on January 1, 2026.

Why is all of this important now? Because the IRS has already announced its position that if a taxpayer does not take advantage of the currently high gift exemption amounts before they are reduced, the benefit will be lost forever. However, a taxpayer who utilizes the higher gift exemption amounts while they are still available will not be penalized if they die after the reduction takes place. A married couple who does not take advantage of this opportunity will unnecessarily leave Uncle Sam a gift of approximately \$4.8 million if the exemption reduces by 50 percent and a gift of approximately \$6.8 million if the exemption is reduced to \$3.5 million for an individual. **The bottom line of all of this is: USE IT OR LOSE IT.**

Increased Transfer Tax Rates: Currently, gifts or estates in excess of the exemption amount are taxed at a flat rate of 40 percent. In addition to reducing the estate, gift, and GST tax exemption amounts, the tax rate could be increased to the 2009 rate of 45 percent.

Repeal of Several Effective Estate Planning Techniques: The following Obama-era tax proposals that could repeal or curtail several very effective planning techniques are potentially in play:

- **Grantor Retained Annuity Trusts.** Eliminate the use of short-term Grantor Retained Annuity Trusts (“GRATs”) by increasing the minimum term from two years to 10 years and by requiring a gift value of at least 25 percent of overall value. A GRAT is an estate planning technique whereby the grantor transfers property to a trust while retaining the right to annuity payments for a term of years. At the end of the trust term, any remaining principal will be distributed to the trust beneficiaries. The annuity amount is frequently set so that the present value of the amount to be paid to grantor over the trust term equals the amount transferred to the GRAT. This technique is called a “zeroed-out” GRAT because it reduces the value of the taxable gift to zero, or close to zero, so that no gift tax exemption is used. However, there is a mortality risk because if the grantor dies before the end of the trust term, the trust property is included in his or her estate for estate tax purposes at its then value, eliminating any gift/estate tax benefit. Therefore, extending the minimum GRAT term to 10 years will eliminate the “zeroed-out” GRAT technique and may effectively eliminate the utility of the GRAT given the mortality risk associated with longer-term GRATs.
- **Dynasty Trusts.** Curtail the use of perpetual trusts by eliminating GST tax exempt status for trusts with a duration of more than 90 years. The GST tax imposes an additional transfer tax (at a 40 percent tax rate in addition to the 40 percent estate tax rate) on transfers made during lifetime or at death to persons more than one generation below the donor. Long-term GST tax exempt trusts, frequently referred to as “dynasty” trusts, allow for trust assets to pass from generation to generation without the imposition of transfer tax. If GST tax exempt status were to expire after a 90-year period, it would greatly diminish the effectiveness of long-term “dynasty” trusts.
- **Family Partnerships/LLCs.** Limit valuation discounts for closely held business interests, including family limited partnerships (“FLP”) and family limited liability companies (“FLLC”). Therefore, individuals who own closely held business interests should consider making

gifts now, while they can still potentially benefit from valuation discounts. It is possible that a distinction would be made between active and passive assets by treating nonbusiness and passive assets (such as marketable securities) as owned directly by the business owners and valuing them without any discounts. Further, individuals who own a controlling interest in an FLP (e.g., as a general partner) or in an FLLC (e.g., as a managing member) should consider making gifts now to relinquish control of these entities to both lock in a discount and eliminate the risk that the retained control will cause the entire FLP or FLLC to be subject to estate tax notwithstanding prior gifting.

Income Tax Changes:

- **Increased Income Tax Rates.** President Biden has proposed increasing the top federal income tax rate from 37 percent to 39.6 percent for taxpayers who make more than \$400,000 a year. In addition, the president has also proposed increasing the tax on capital gains and qualified dividends from 20 percent to 39.6 percent for taxpayers who make more than \$1 million a year.
- **Repeal of Step-Up in Basis at Death.** President Biden has proposed repealing the long-standing step-up in basis for the capital gains tax. Under current law, inherited assets receive a basis equal to their fair market value as of the decedent's date of death. As a result, a beneficiary does not have to pay capital gains tax on any pre-death appreciation in the asset's value. If the step-up in basis at death is eliminated, a beneficiary inheriting a highly appreciated asset will likely have to pay much higher income taxes when the asset is ultimately sold.

WHAT ARE SOME OF THE AVAILABLE PLANNING OPPORTUNITIES?

While it is possible that any tax law changes could be made retroactive to January 1, 2021, it seems much more likely that any changes would be effective upon the date that legislation is introduced or enacted. As such, there still may be time to take advantage of planning opportunities before changes are enacted into law.

Use it or Lose It: As mentioned above, the high transfer tax exemptions are scheduled to be reduced by 50 percent in 2026, but will more than likely be reduced sooner and more possibly by more than 50 percent. Individuals must therefore use their increased exemptions before the law changes, or risk losing them forever. Current IRS guidance provides that gifts made while the higher exemption levels are in effect will not be subject to a "clawback" if the exemption is reduced in the future. Therefore, individuals and married couples should consider making gifts now while they still can, recognizing the fact that the gifted assets will be received by the donee with a carry-over tax basis.

Low-Interest Rates: Due to current economic conditions, interest rates are at historically low levels. While the rates have been slowly increasing, they are expected to remain low for some time, including the IRS-sanctioned interest rates (the so-called "Applicable Federal Rate" or "AFR" and the "Section 7520 Rate"), which are used for many estate planning techniques. This low interest environment is ideal for implementing new intrafamily loans, as well as refinancing existing loans with higher interest rates. *For example, at the March 2021 rates, the minimum required interest rates would be only 0.11 percent for a loan term of three years or less, 0.62 percent for a loan term of more than three years but less than nine years, and 1.60 percent for a loan term of nine or more years.* These loans will not use any gift or estate tax exemption and could be converted to gifts at a later date depending on the state of the law at the time. **This technique is suitable for all clients, even those who have already used all or most of their tax exemptions.**

GRATs: A GRAT is an estate planning technique that allows for the transfer of appreciation of assets at minimal or no gift tax cost. In order for a GRAT to be effective, its assets must grow at a greater rate than the Section 7520 Rate, which is 120 percent of the mid-term AFR. *For March 2021, the Section 7520 Rate is only 0.8 percent.* Therefore, any appreciation of the GRAT's assets in excess of 0.8 percent per annum will pass to the GRAT's beneficiaries free of any gift or estate tax. As mentioned above, it is possible that the short-term GRAT may be completely

eliminated. Consequently, individuals who have been considering this technique should consider implementing a GRAT now before any potential tax law change goes into effect. **This technique is also suitable for all clients, even those who have already used all or most of their tax exemptions.**

Spousal Lifetime Access Trusts (“SLATs”): A SLAT involves a gift from one spouse to an irrevocable trust from which the other spouse may benefit in the future. The gift to the SLAT will utilize the donor’s exemption and the post-transfer appreciation on the trust’s assets that is not distributed to the spouse will not be subject to future gift, estate, and possibly GST tax. One of the major benefits of a SLAT is that it allows your spouse continued (though limited) access to trust income and/or principal. **A SLAT is a particularly attractive technique for ultra-high-net-worth and high-net-worth clients who want to take advantage of the increased exemption amounts but feel financially uncomfortable relinquishing access to the gifted assets if needed in the future.**

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Blank Rome’s [Private Client](#) team is uniquely situated to navigate the many effective planning options available under current law, which can change at a moment’s notice. Everyone has their own unique situation, but whether you fall into the ultra-high-net-worth or high-net-worth categories above, we urge you to reach out to us to discuss what works best for you and to be in a position to implement your decisions before the door closes on these planning strategies.

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