INSIGHTS REPORT

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Today's Taxes, Tomorrow's Turmoil?

Understanding how estate taxes may change and what to do about it

With multiple legislative proposals on the table that may impact your clients' estates, now is the ideal time to partner with a trust expert to ensure that beneficiaries are protected.

INSIGHTS REPORT

If you've been following the financial and political news over the past months, you already know there's rampant speculation about what could happen if any or all of the American Families Plan proposed by President Joe Biden is enacted into law.

Financial professionals and their clients are scrambling to understand the impact of the proposed legislation, and clients are contemplating changes to their financial and estate plans before anything is even debated or signed into law.

Certainly, for high-net-worth investors, estate taxes are important — **but your clients shouldn't overthink the details of what may happen to these taxes in the future.** In the realm of estate planning, it pays to keep the big picture in mind and focus on what's most important: planning in the best interests of beneficiaries.

Proposed Changes

Estate Tax Rate
40% > 45%

Exemption
$11.7 M > $5.3 M

Removal of Step Up in Basis

Annual Gift Exemption
$15,000 per donor, per recipient > $20,000-$50,000 total for all

The first and foremost reasons to have an estate plan are to protect minor beneficiaries or to protect adult beneficiaries from bad decisions, outside influences, creditor problems, and divorcing spouses. Or, as the phrase goes, from predators, creditors, in-laws, and outlaws.

Part of creating a plan that reflects your clients' wishes and addresses the concerns they have for their family and assets is, of course, tax consideration. But the reality is that **we can only make decisions in today's environment within the parameters of the laws and rules in place now**, while keeping in mind that estate exemption amounts and rates are likely to change in the future.

If the proposals being set forth by the Biden administration in the American Families Plan are adopted, they could be historic in their scope — but this is hardly the first time that tax laws have been through significant changes.

The modern estate tax introduced into law in 1916 has changed dozens of times. For example, the exclusion amount has risen from $60,000 at the end of World War II to $11.7 million today.

Additionally, the top estate tax rate, which was 77% at the end of WWII, has fluctuated downward decade by decade and now sits at just 40%.

The current version of proposed legislation omits (for now) President Biden's campaign plan to raise the estate tax rate from 40% to 45% and lower the exemption from $11.7 million to $5.3 million.

However, there are several proposals in the Senate, including Bernie Sanders' For the 99.5% Act, which would lower the exemption to $3.5 million (as it was in 2009) and change the rate structure to 50% for estates over $10 million up to 65% for estates over $1 billion.

How We Got Here

$60,000
Post-WWII Exclusion

$3.5 M
Exclusion in 2009

$11.7 M
Exclusion in 2021[1]

$5.3 M
Proposed Exclusion

1. The current exemption amount is slated to expire after 2025, at which time it will revert to its pre-2018 level ($5.49 million) unless Congress acts.

THE MOST SIGNIFICANT CHANGE

The American Families Plan would end a rule that has been a cornerstone of estate planning for generations of wealthy Americans: the step up in basis for assets passing at death.

According to the proposed legislation, the reform "will be designed with protections so that family-owned businesses and farms will not have to pay taxes when given to heirs who continue to run the business."

Treasury Secretary Janet Yellen has stated that elimination of the step up in asset basis at death is a priority for the Biden administration. Many believe that these changes will occur in legislation expected to be enacted this fall.

Today, people who own assets that have boomed in value — stock in Apple or Google, the family home, cryptocurrency — don't pay capital-gains taxes unless they sell.

Under the Biden proposal, those unrealized gains would trigger taxes upon the owner's death, minus a $1 million per-person exemption. More than two-thirds of all U.S. families have some unrealized capital gains, according to the Federal Reserve, but most would be covered by the $1 million exemption.

For families in the top 10%, with a median net worth of $2.6 million, median unrealized gains are $519,000.

No single change to tax law would have a greater effect on the distribution of inherited wealth than the elimination of the step up in basis for inherited assets.

The taxation of previously untaxed gains would be a major change in federal tax policy, one that would greatly complicate the administration of estates.

More than 2/3 of all U.S. families have unrealized capital gains

Source: The Federal Reserve

OTHER POSSIBLE CHANGES

There are several technical adjustments not in the American Families Plan but contained in Biden's campaign plans or other proposals. Three of the changes would be relatively easy to enact.

End Short-Term Trusts that allow people to pass tax-free to their heirs expected appreciation (for example, from the sale of a private business)

Limit Tax-Free Gifts that can be given each year to trusts for funding things like life insurance to pay estate taxes.

Curtail Special Tax Treatment that family partnerships receive, even when they own liquid securities and not an operating business.

TIMING THE NEW TAX LAWS

It's important not to overreact or to let political leanings color your decisions when contemplating the proposed legislation. Tax increases are complex to implement, and due to the lack of political will to impose new taxes during a pandemic, the changes may take some time. It is possible we may see a wave of tax code changes during 2021, all with an effective date of January 2022. Given the current deadlock in Congress, the most practical avenue to pass a tax law is through the budget reconciliation process, which would require the support of all Democratic senators.

There may be enough moderate Democrats (like Manchin, Warner, and Sinema) that we may see modifications to the proposals before they win support. We should also consider the Treasury Department's "Green Book" before making any estate planning decisions based on the proposed changes.

Overall, it is important to remember that the scope and magnitude of all tax proposals, whether individual, corporate, or estate taxes, are aspirational and are unlikely to be enacted "as-is" given the legislative process and political considerations.

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HOW TO PLAN FOR CHANGE

So, what should you advise a high-net-worth individual to do given the potential for major estate tax law changes?

Help them carefully consider their options, ideally in partnership with a corporate trustee.

The reality is that some of the primary tax-mitigating tools and strategies we use today may no longer be available in the future. And these changes are likely to begin on the date President Biden signs the bill into law.

1. **Max out the annual gift exclusion** before the law changes or the year ends.

2. When it comes to the **lifetime gift exemption, use it or lose it.** A reduction in the exemption amount in a new bill may not result in a recapture or "clawback" of completed gifts.

3. **Fund a Grantor Retained Annuity Trust** (GRAT) with appreciating assets. The current GRAT hurdle rate is 0.6%, which is the lowest it has ever been. If the investments placed within a GRAT outperform that rate over the GRAT term, the growth will be passed to beneficiaries tax-free.

4. Create a Charitable Trust that **pays your client or their loved ones benefits** while living.

5. **Don't wait!** If it appears unlikely that any estate tax laws will be passed this year, there will be a rush of individuals seeking to make large gifts toward the end of 2021.

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For more estate planning strategies and ideas, talk to the experts at Arden Trust.