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Proposed Changes to the Estate and Gift Tax Laws

As the year 2020 draws to a close, and the word "unprecedented" begins to wear thin, tax planning remains an ever-important goal. Although the details of President-elect Biden's gift and estate tax proposals are currently limited, there are several items on the Democratic Party's agenda that, if enacted, would profoundly impact estate planning strategies.

The final composition of the Senate remains uncertain until January, 2021. It is therefore even more unclear whether and when any such proposed reforms will be enacted, and if they are, what their final form will be. Given the current political environment, tax legislation bearing on estates and gifts, while possible, is unlikely to have a retroactive effective date as of January 1, 2021. Nevertheless, those who are already inclined to take advantage of the current favorable tax rules may wish to act at this time to remove any risk.

This discussion is intended only to address select proposed changes to the current gift and estate tax regimes and related planning strategies.

The Journey from Proposals to Enactment

After every election, campaign promises must eventually succumb to the bureaucratic reality. The direction of that reality will, at least in part, be decided by the outcome of two run-off elections taking place in Georgia on January 5, 2021.

If the Republican candidates win even one of the run-off elections, the Republican Party will retain a majority in the Senate. With a divided legislative branch, it seems likely the focus would shift to a bi-partisan agenda. If the Democratic candidates win both run-off elections, assuming the independent senators would generally align with the Democrats, the Senate would be divided, with Vice President-elect Kamala Harris potentially casting the deciding vote in partisan divides. However, even if the Democratic candidates win both run-off elections, sweeping tax legislation is far from a sure thing.

Most recent, major tax bills have been enacted through the budget reconciliation process because it only requires a simple majority and avoids the filibuster in the Senate. To use this path, Congress first must agree on a budget resolution that sets guidelines for revenue and spending for congressional committees.

Once the budget resolution has passed, any legislation remains limited under this process. In particular, the "Byrd rule" would likely stand in the way of any legislation that would (a) not be revenue neutral, (b) increase the deficit beyond 10 years and/or (c) make changes to Social Security. To make any of the foregoing changes, 60 votes are generally required. Even if a proposed tax plan would not run afoul of the Byrd rule, given the tight margins in the Senate, any legislation could fail if even one Democratic or independent senator does not support it.

Proposed Changes to Transfer Tax Exemptions and Rates

In 2017, the lifetime federal gift and estate tax exemption and the generation-skipping transfer (GST) tax exemption were doubled to $10 million, indexed for inflation. For 2020, the exemption amounts are $11.58 million and, under the current law, the exemption amounts will continue to increase with inflation annually through 2025, unless the law is repealed or amended prior to that time. Even if not repealed, the increased exemption amounts are scheduled to sunset and revert to the 2017 levels (as adjusted for inflation) beginning January 1, 2026. The IRS has issued regulations clarifying that there will be no claw-back of gifts made if the exemptions are subsequently reduced.

Gratuitous transfers (whether made by lifetime gift or at death) in excess of the gift and estate tax exemption amount incur a flat 40% tax, in addition to any applicable generation-skipping transfer taxes (also currently taxed at 40%). Even after the sunset of the 2017 tax law changes in 2026, the rate remains at 40%.

President-elect Biden's tax plan (as published on October 26, 2020) indicates that a Biden administration would seek to revert the gift, estate and GST tax provisions to what they were in 2009. That is, the gift tax exemption was $1 million and the estate tax and GST tax exemptions were $3.5 million. The highest gift, estate and GST tax rates were 45%. It has alternatively been speculated that a Biden administration would pursue accelerating the sunset of the increased exemption amounts, reverting back to $5 million, adjusted for inflation, before 2026.

Leading up to the election, there was a great deal of speculation that, if the Democratic party took control of the White House, the House of Representatives and the Senate, the exemption amounts could be reduced, effective as soon as January 1, 2021. Although it seems unlikely that any tax law changes would be implemented so quickly, donors who are inclined to use their expanded exemption amounts may still consider doing so prior to year-end.

Key Planning Considerations for Lifetime Gifts

There are a number of reasons to consider making significant lifetime gifts.

Generally, lifetime gifts make sense because once assets are transferred outside of the donor's estate, the future appreciation of those assets is removed from the donor's estate and flows to the beneficiaries. In the current planning environment, making the gift prior to year-end may give donors the added benefit of peace of mind – gifts completed prior to year-end should not be adversely impacted by future reductions to the exemption amounts or increased tax rates.

Moreover, there are circumstances where it may even make sense to make taxable gifts after a donor has used all of his or her exemption. Due to differences in the ways gift taxes and estate taxes are calculated (tax exclusive and tax inclusive, respectively), it is often considered to be less expensive (or more tax efficient) to make a lifetime gift rather than a bequest at death. For example, all things being equal, under the current law, it costs $1.4 million to make a gift of $1 million (net of tax), but $1.67 million to make a bequest of the same amount. In the many states, such as New York, that impose an estate tax (but not a gift tax), it costs nearly $2 million to make the same $1 million bequest. This difference becomes more pronounced as tax rates increase.

However, there are a number of state tax considerations that must also be carefully navigated when deciding to make large gifts. For example, in New York (and select other states) making a lifetime gift may actually increase the donor's estate tax liability if the donor dies within three years of the gift due to a claw back rule. Connecticut residents must also consider the state gift tax on transfers above the state exemption (currently $5.1 million, scheduled to increase to $7.1 million effective January 1, 2021).

When deciding to make gifts in response to the possible changes in the law, there are additional considerations. The timing of gifts that would not utilize any of the 2017 expanded exemption amounts (together with the donor's prior gifts) is less critical. To the extent gifts (together with prior gifts) will not use more than $3.5 million (or perhaps more likely $5.5 million) of one or more of the donor's exemptions, the donor will not have taken advantage of any of the expanded exemption amounts.

Unless planning very large gifts, married couples may also decide not to split their gifts so as to maximize the use of one spouse's expanded lifetime exemption. If one spouse makes the full gift, it may be possible to preserve the second spouse's remaining exemption in the event the law is changed.

Proposed Elimination of the Step-Up in Basis

Another key element of estate tax reform in President-elect Biden's tax plan is the repeal of the step-up in basis of assets at death.

The repeal of the step-up would most likely come in one of two forms: the first would tax the unrealized appreciation in the decedent's assets at death; the second would be that the beneficiaries of the estate would inherit the decedent's basis in the assets. In the first case, death would be a deemed disposition and the estate would likely be required to pay a mark-to-market tax on the appreciation. In the second case, a beneficiary receiving an appreciated asset would likely only be required to recognize the decedent's gain upon sale of the asset. It is unclear whether the repeal of the step-up would work in conjunction with, or in lieu of, the estate tax.

The step-up has been eliminated twice in recent history. The first time, in 1976, the beneficiaries of an estate would have received the decedent's carry-over basis in the assets. The law proved so unworkable (in part due to the inability to resurrect records) that it was repealed before it ever took effect. The second time, in 2010, the beneficiaries would again receive the decedent's carry-over basis unless the estate elected to pay an estate tax, in which case the beneficiaries would receive the stepped-up basis. Once again, the law was wildly unpopular, difficult to administer, and lasted only one year.

Although eliminating the step-up in basis has not proved workable in the past, technological advancements certainly make tracing carryover basis more feasible (at least more than it was in the 1970s). Furthermore, that other countries, such as Canada which has a mark-to-market regime, have successfully implemented such systems may counter the practical challenges to eliminating the step-up.

Proposed Changes to Grantor Retained Annuity Trusts (GRATs)

Simply put, a GRAT is an estate freeze technique that allows donors to give away future appreciation beyond the IRS hurdle rate (0.6% for December 2020). GRATs can be structured to result in a near-zero gift ("zeroed-out"), meaning property may be passed without incurring a gift or estate tax. A GRAT only works if the donor survives the annuity period. In order to minimize this mortality risk, short-term GRATs are often used (for example, with a two-year annuity period). Short-term GRATs allow donors to isolate periods of appreciation (where a GRAT can be effective) from those periods of depreciation (which would otherwise drag down the performance of the GRAT).

Zeroed-out GRATs are a particularly attractive wealth-transfer vehicle because they are effectively a risk-free option. If the GRAT is successful, the donor removes the appreciation that occurred during the annuity period from his or her estate, as well as any future appreciation on that property, without paying any gift or estate tax. If the GRAT is unsuccessful (whether because the assets did not appreciate as anticipated or because the donor passed away during the annuity period), the donor is essentially in the same position as if the gift had not been made.

Perhaps because GRATs have been such an effective wealth-transfer vehicle, they have recently been the focus of increased public scrutiny. Recent legislation introduced to the Senate and House would require GRATs to have a minimum duration of 10 years and that the gift tax value of the remainder interest passing to the individual beneficiaries be at least 25% of the value transferred to the GRAT. This would drastically reduce the attractiveness of GRATs. Requiring donors to use part of their exemption or incur a gift-tax upon funding changes the risk-free nature of the technique. In addition, if the annuity period of the GRAT is longer, there would be a higher risk that the donor would die during the term, thereby increasing the risk that the GRAT may not be effective. Further, with a longer annuity period, it becomes more difficult to capture future appreciation within the GRAT structure, while limiting the dilution effect of potential depreciation.

While meaningful changes to the current GRAT rules seem unlikely to be a priority for the Biden administration in 2021, it is possible that changes to the GRAT rules may be used as a bargaining chip in the context of negotiations for other legislation.

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There is no one-size-fits all estate plan and each family's situation and needs are different. For those who wish to discuss the best techniques for their individual circumstances, we welcome the opportunity to discuss these issues with you.

This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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