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Proposed tax changes

Estate planning in light of potential tax reform

PROFESSIONAL OPINION



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Prior to Joe Biden's Electoral College victory over former President Donald Trump, Mr. Biden campaigned on a comprehensive tax plan (the "Biden Plan") including proposals related to individual income, corporate, and estate and gift taxes. This article focuses on the Biden Plan proposals concerning estate and gift taxes. Here's an overview:

The Biden Plan proposes to decrease the federal estate tax exemption amount (currently \$11.7 million per person or \$23.4 million per married couple) either to \$5 million per person (\$10 million per married couple) or to the pre-Tax Cuts and Jobs Act exemption amount of \$3.5 million per person (\$7 million per married couple). The reduction of the federal estate tax exemption amount is coupled with a proposal to increase the top federal estate tax rate from 40% to 45%. Although the Biden Plan does not include a "wealth tax," it does propose to repeal the step-up in basis at death and — perhaps — to also tax unrealized capital gains at death.

Inquiring minds want to know: Procedurally, how will the Biden administration and Congress attempt to enact the Biden Plan tax proposals? What is the likelihood of enactment? If enacted, is it possible for the effective date to be made retroactive to January 1, 2021? If so, how might estate planning clients plan for such retroactivity?

Congressional procedures: The process of "reconciliation" can be used as a method for the U.S. Senate to enact budget legislation with only a majority vote. This avoids the threat of a filibuster,

which requires 60 votes to overcome. Given that both political parties now each have 50 seats in the Senate, budget reconciliation would succeed if both parties vote in blocs and the Vice President casts the tie-breaking vote.

It seems likely that budget reconciliation may be attempted to advance the Biden Plan in the Senate. Typically, Congress may only use the reconciliation process to pass one budget bill each fiscal year (ending September 30). The last Congress did not pass a budget bill for the fiscal year ending September 30, 2021. At this point, it appears congressional Democrats will use reconciliation to pass COVID-19 relief during this current fiscal year. It is possible that Democrats may craft a second reconciliation bill later this year (for fiscal year 2022) that would include elements of the Biden Plan, including estate and gift tax reform.

Likelihood of enactment: Although transfer tax rates have gone up and down in the past, the federal transfer tax exemption amount has only gone up, and has never gone down before, and prior attempts to repeal the step-up in basis have not been successful. Although, as they say, there's a first time for everything, the Biden administration and the Democrats in Congress face a tough row to hoe as far as these specific estate and gift tax reforms are concerned.

Retroactivity: Typically, tax legislation is enacted prospectively. Sometimes, however, legislation is made retroactive. If the Biden Plan (or some version of it) is enacted retroactively this year, it would either be effective as of its date of introduction in Congress or, possibly, as of January 1, 2021. Retroactive enactment of the Biden Plan proposal to significantly lower the federal transfer tax exemption amount could prove problematic for clients who may wish to take advantage of and utilize their current "enhanced" exemption amount, as discussed in more detail below.

Planning for retroactivity: As the end of calendar year 2020 approached, many wealthy estate planning clients engaged in planning designed to utilize their 2020 federal transfer tax exemption amount (\$11.58 million per person or \$23.16 million per married couple), for fear that the exemption amount would be lowered in accordance with the Biden Plan in 2021. This planning typically involved large taxable gifts, oftentimes made to irrevocable trusts. One popular planning vehicle was the "spousal lifetime access trust" (SLAT).

A client who engaged in this type of planning prior to the end of 2020 can rest assured that, even if the federal estate tax exemption amount is reduced to a level which is below the amount of the client's taxable gift (either under the Biden Plan or pursuant to current law in 2026 — when the federal exemption is scheduled to revert to the 2017 level of \$5 million, as adjusted for inflation), the law will not impose an estate tax on the client's previously untaxed gift at the time of the client's death (known as "clawback") — thanks to Treasury regulations issued by the IRS in 2019 which were designed to avoid clawback.

Before the federal transfer tax exemption amount

is possibly lowered pursuant to the Biden Plan, clients still have an opportunity this year to utilize their current exemption amount by making large taxable gifts. But, given the possibility of retroactivity, such clients should be advised to consider certain techniques that may be used to unwind the gifts to avoid unintended gift taxes.

Clients should consider plans which allow their intended beneficiaries to disclaim gifted assets back into the hands of the client (within nine months after the date of the gift — plenty of time to wait and see whether the Biden Plan is enacted retroactively this year).

Clients should also consider planning with "qualified terminable interest property" (QTIP) elections. For example, a SLAT could be designed to qualify for the marital deduction if a QTIP election is made against the trust. If no election is made, the gift would instead be deemed to pass to a non-qualifying trust for the benefit of the donor's spouse that would utilize the donor spouse's transfer tax exemption amount. The decision as to whether to make a QTIP election would not have to be made until the following calendar year when the gift tax return is due, and then depending on whether any reduction of the federal transfer tax exemption amount is made retroactive to January 1, 2021.

Finally, clients should consider making gifts using a formula transfer clause. The client would make a gift of a fractional interest of an asset where the numerator is the client's available exemption on the date of the gift and the denominator is the fair market value of the gifted asset, as finally determined for federal gift tax purposes. If the exemption amount on the date of the gift is reduced retroactively, the formula would "self-correct" so that the donor's gift is only an amount equal to the donor's available exemption on that date.

In any case, despite all the hurdles facing the enactment of the Biden Plan in Congress, and however unlikely it may be that tax reform legislation will be made retroactive to January 1 of this year, clients who are intent on using their current federal transfer tax exemption amount are urged to meet with their professional advisors to discuss their planning sooner rather than later.

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