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Could Biden's Gift-and-Estate Tax Plan Cost Your Affluent Clients?

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What You Must Know—And What to Do About It

The Biden-Harris Administration's proposed tax changes under the American Families Act (AFA) are designed to (a) require high-income taxpayers to pay their "fair share" of taxes and (b) provide relief to low and middle-income filers, mainly in the form of expanded tax credits[1]. (For an overview of those tax proposals, refer to our March Advanced Markets Explained white paper, "What's Next: The Biden Administration's Stimulus and Tax Plans.")

In March, the $1.9 trillion American Rescue Plan Act (ARPA) became the sixth stimulus package designed to help Americans recover from the ongoing impacts of the COVID-19 pandemic. ARPA's tax breaks aim to provide income tax relief, mainly to lower and middle-income taxpayers. The AFA plan is to offset the resulting costs by imposing increased gift and estate taxes as well as steeper income taxes on high-net-worth (HNW) and high-income Americans.

Two of AFA's proposed changes could significantly impact wealth transfers for your HNW clients. That's the bad news. The good news is that there are strategies to help mitigate potentially higher transfer taxes, such as the use of life insurance.

The Future of the Unified Estate and Gift Tax Exemption is on Shaky Ground

The Trump Administration's Tax Cuts and Jobs Act of 2017 made significant changes to individual and corporate income tax rates. Moreover, the individual unified estate and gift tax exemption gradually increased from $5.4 million in 2017 to $11.7 million in 2021. (Double those numbers for married couples.) That increase is slated to sunset at the end of 2025 and return to prior levels, barring new legislation to accelerate or repeal the current tax regime[2].

The Biden-Harris Administration is on record about its intent to dismantle the Trump tax cuts sooner than 2026, so you should be discussing plans of immediate action with your clients. The AFA calls for the now-unified estate and gift tax exemption to be replaced with a dual system: an estate tax exemption of $3.5 million and a gift tax exemption of $1 million. (Double those numbers for married couples.)

The decoupling of the exemption amounts would make it more challenging for individuals and couples with estates teetering near or above $3.5 million or $7 million to reduce their taxable estates through large lifetime gifts. The current gift tax annual exclusion amount of $15,000 would remain intact but could be capped at a maximum per donor under the new Administration; the current annual exclusion rule permits $15,000 in gifts to be made to an unlimited number of recipients.

What could such reductions in the gift and estate tax exemption amounts mean for your clients and prospects? If enacted, the number of people facing gift and estate tax exposure could increase exponentially from the highly affluent minority currently concerned to the more numerous moderately wealthy. What's more, AFA would implement a top estate tax rate of 45%, up from the current 40%.

With these potential transfer tax hikes to consider, here are some action plans to discuss with specific clients:

Strategy #1 – Encourage Gifting Now

Since 2021's agenda is still primarily focused on pandemic relief, it's likely that any decoupling of the estate and gift tax unified credit and any reduction in exemption amounts won't take effect until 2022 at the earliest. Gifting now probably will lock in the $11.7 million or $23.4 million exemption for gifts completed in 2021.

Even if a stricter gift-and-estate tax plan passes in 2021, the likelihood of retroactivity to January 1, 2021, is slim to none. Furthermore, the Treasury Dept. issued final regulations under IR-2019-89 confirming that the scheduled reduction would not adversely impact large gifts made under the increased estate and gift tax exemption amounts through 2025 to prior amounts in 2026[3]. As a result, it is relatively safe to assume that this Treasury position would remain effective if a new tax law takes effect sooner.

As mentioned, the annual exclusion gift per recipient is $15,000 ($30,000 for a married couple). This amount may be gifted to any number of individuals in 2021 without reducing the giver's gift and estate tax exemption. Still, it remains unclear if a cap will be imposed on this annual exclusion under the Biden tax plan.

Strategy #2 – Purchase Life Insurance to Pay Potential Estate Tax

For clients with estates close to the danger zone of estate taxation under AFA, discuss leveraging life insurance to provide death benefits that can help pay any estate taxes—keep in mind that estate taxes are due in cash within nine months of death. Too often, without proper planning, selling illiquid assets like a home may be the only viable tactic to pay an estate tax bill. Life insurance proceeds, generally income tax-free, may eliminate the need to resort to a fire sale of other assets, potentially at a reduced price, to pay estate tax. Such assets can then pass intact to intended heirs.

Strategy #3 – Transfer Ownership of a Life Insurance Policy to an Irrevocable Life Insurance Trust (ILIT)

One possible flaw with Strategy #2 is that although the use of life insurance to pay estate taxes is an excellent leveraging technique, the insurance payout will be includable in the overall estate if the decedent has any incident of ownership at death. The best way to avoid this outcome is to hold the policy in an irrevocable life insurance trust (ILIT).

Once a policy is transferred to an ILIT, any incident of ownership must be removed. To do so, the insured individual owner may not be the ILIT's trustee; he or she may also not receive any benefits from the policy.

Instead, the policy must be owned by the ILIT, and the trustee must follow the instructions outlined in terms of the trust regarding how the death benefit is to be distributed. Beyond removing the value of the ILIT from the gross estate, any future potential growth of the value of the assets within the ILIT will no longer inflate the estate. Properly executed, using an ILIT avoids estate tax on the death benefit while creating a source of liquid cash to pay any estate tax due and other expenses.

3-Year Lookback Rule

Under the tax code, the proceeds of a life insurance policy gifted to an irrevocable trust within three years of the insured individual's death must be included in the decedent's gross estate[4]. The sooner such a transfer is executed, the sooner this potential tax trap will expire. (Arranging for the ILIT to acquire a newly issued policy can sidestep this rule.)

Strategy #4 – Make Charitable Donations

Direct gifts made to qualifying charities are exempt from the $15,000 annual gift tax exclusion limit and the unified gift and estate tax exemption amount. Another option is to transfer wealth to a charity through a charitable trust.

A charitable lead trust (CLT) provides upfront charitable donations and a corresponding income tax deduction for the value of the gift. At the donor's death or after a number of years, the remaining value of the trust is paid to the beneficiaries. The CLT is not included in the value of the gross estate.

A charitable remainder trust (CRT) is a CLT in reverse: income to individuals followed by a charitable donation. One common plan is to transfer highly appreciated assets to a CRT. Once transferred to the trust, the assets are sold, and the grantor avoids paying capital gains tax. Specified beneficiaries receive an income stream for life or over a period of years, after which the remaining interest is paid to charity. Non-qualified annuities are frequently used within a CRT to provide required income. However, it's recommended that annuities not be the only asset within the CRT so that the required income payout rules are not disrupted by having only one type of asset from which to draw the income stream.

Both the CLT and CRT remove the transferred assets from the donor's gross estate and also provide an immediate income tax deduction for the present value of the assets going to charity. To compensate for the relinquished assets, a CRT's income stream or CLT income not going to charity may be used to purchase life insurance, in an ILIT if inflation of the estate is also a concern for the donor's heirs to receive at the insured individual's death.

Elimination of Stepped-up Basis at Death for Wealthier Americans

AFA also calls for an end to "capital income tax breaks and other loopholes for the very top"[5] by increasing the maximum capital gain and dividend tax rate from 20% to 39.6% on households earning over $1 million. The proposed law would also tax unrealized capital gains of over $1 million at death ($2.5 million per couple when combined with real estate exemptions). It is unclear whether pre-death gain below the $1 million threshold would receive a carryover basis (without immediate taxation) or be taxed immediately at death. What is clear is the intent to eliminate the existing stepped-up basis rules, whereby the basis of a capital asset is stepped up to the fair market value as of the date of death[6]. Under the current regulations, beneficiaries avoid paying capital gains tax on income over basis up to the point of death. They will only pay capital gains on income earned after the date of death upon the asset's sale. Exceptions to the revision of stepped-up basis rules include donations to charity and family-owned businesses and farms in which heirs continue to direct the enterprise.

What Assets Receive a Stepped-up Basis?

Under current law, if an heir inherits a capital asset such as stock, a home, or investment property, the asset's basis (cost for tax purposes) increases to the fair market value as of the date of death (or an alternate valuation date in limited cases). Only subsequent gain is subject to capital gains tax when the asset is sold. AFA would change that method by requiring taxpayers to retain the decedent's basis in certain assets, often resulting in a more considerable gain on an eventual sale.

Strategy #5 – Could Non-Qualified Annuities be a Solution?

Long seen as a tax benefit not extended to annuities, elimination of the basis step-up could boost the appeal of annuities as a legacy planning tool. Non-qualified annuities were not included in the SECURE Act's elimination of the attractive stretch feature of qualified annuities, including those held in IRAs, thus replacing extended tax deferral for qualified annuities with a maximum 10-year distribution period.

Distributions from inherited non-qualified annuities, on the other hand, still may be stretched by a designated beneficiary over a period based on life expectancy, provided annual distributions begin within one year of the decedent's death. AFA does not seem to address the potential of non-qualified annuities for passing extended tax-deferred wealth to heirs.

Strategy #6 – Harvest Capital Gains Now to Fund Life Insurance or Annuities

Considering the potential for higher capital gains tax rates and carryover basis on inherited assets, this year may be the time to take capital gains at a 15% or 20% tax rate (before a possible 3.8% surtax). One strategy would be to take gains and use the after-tax dollars to purchase life insurance or annuities. Should the proposed increases to capital gains taxes come to pass, leveraging the opportunity to shift to tax-favored, non-capital gain assets could reduce overall tax liability during a client's lifetime and after death.

Be Prepared

Tax proposals don't become law until enacted, and even then, it takes time to decipher the details and discover the real impact of new legislation. Nevertheless, it's clear that the Biden-Harris Administration intends to impose higher taxes on those with high-end income or net worth.

Discussing the probable outcomes with clients and suggesting solutions such as those described above may lead to substantial tax savings—and soaring client satisfaction. Although we can't precisely predict the future, having contingency plans in place to hedge the real risk of high taxes is bound to boost your business long-term.

Always encourage your clients to seek guidance from his/her tax professionals before following a proposed course of action.

Sources:

[1]https://www.whitehouse.gov/briefing-room/statements-releases/2021/04/28/fact-sheet-the-american-families-plan/

[2]https://www.irs.gov/businesses/small-businesses-self-employed/estate-tax

[3]https://www.irs.gov/newsroom/final-regulations-confirm-making-large-gifts-now-wont-harm-estates-after-2025

[4]https://www.law.cornell.edu/uscode/text/26/2035

[5]https://www.whitehouse.gov/wp-content/uploads/2021/04/American-Families-Plan-Fact-Sheet-FINAL.pdf

[6]https://www.irs.gov/faqs/interest-dividends-other-types-of-income/gifts-inheritances/gifts-inheritances