Summer 2021

Estate Planning Update Summer 2021 - Tax Planning in an Uncertain World-Is Liquidity the Answer?

We are halfway through the first year of the Biden administration, and if you are a tax professional, it is hard to go a day without discussing and reading about possible changes to the tax law. If you aren't a tax professional, we hope you have other things to think about, but there are still headlines, editorials and plenty of speculation coming across your plate. How does one make sense of it all and move forward with proper tax planning?

Over the past year, there was considerable speculation, when a Democratic sweep of the presidency and Congress seemed possible or likely, about a potential reduction in the federal estate tax exemption, possibly one that would be retroactive to January 1, 2021. See "Retroactive Tax Legislation and Gift Planning in 2021" for a good discussion of planning for retroactivity. Many wealthier clients made gifts last year to utilize their exemptions, based on Biden's proposed exemption reduction, Democrats retaining control of the House and the possibility of Democratic control of the Senate, which became a reality after the special elections in Georgia in January.

So far this year, the Democrats have shown they can pass major legislation even with the narrowest possible majority in the Senate, and they have made ambitious proposals on subjects like infrastructure, election reform and, yes, taxes.

Senator Bernard Sanders, I-VT, introduced the "For the 99.5% Act," which proposes major changes to the gift, estate and generation-skipping transfer taxes, including an increase in gift and estate tax rates. Proposals have been made that would eliminate the step-up in basis at death, and either impose income tax when those gains are realized by the recipient or impose an immediate income tax on unrealized gains at death. Senator Elizabeth A. Warren, D-MA, proposed a wealth tax on people with a net worth in excess of $50 million. At the same time, concerns that tax changes might be made retroactive to the beginning of 2021 seem to have faded.

Of course it is a long way from legislative proposal to law. Even if directionally it seems possible or even likely that we will see tax increases that impact wealthier families, it remains impossible to predict what proposed changes might emerge as law and when they might take effect. While we cannot predict the future, we can make recommendations for how best to plan for your loved ones in today's environment.

For those who have sufficient assets, making gifts now continues to have advantages over waiting until later. See our summer 2020 article "Estate Planning Necessities and Opportunities in Today's Environment" for an overview of wealth transfer opportunities, including gifts to trusts, loans, grantor-retained annuity trusts, installment sales to grantor trusts and other techniques.

If you are concerned about changes in tax law happening with little warning but don't want to make large gifts yet, having an irrevocable trust in place and funded with at least a modest gift can help facilitate making gifts quickly. Additional helpful steps would be to identify assets you intend to gift and put a plan in place for completing the transfers. For example, with advance planning, it may be easier and quicker to implement forgiveness of a loan or the transfer of an interest in a limited partnership or limited liability company than to engage in other types of transfers. There is of course no guarantee that there will be sufficient warning about a change in the law.

While people typically look to make gifts within their federal gift and estate tax exemptions ($11.7 million per person in 2021), making gifts in excess of exemptions and paying gift tax may be advisable for some wealthier people. Even if tax rates do not increase, the effective gift tax rate is lower than the estate tax rate for those who live for at least three years after making the gift. If one anticipates higher gift and estate tax rates in the future, there may be an added incentive to pay gift tax now.

Some people look at an anticipated increase in capital gains tax rates and consider incurring capital gains sooner than they otherwise would in order to lock in current income tax rates. It may make sense to accelerate gains to some extent, but careful consideration should be given not only to potential increases in federal income tax rates but also to the resulting income tax impact and the potential loss of the stepped-up basis on death, if not eliminated by new legislation.

Possible Next Steps—Liquidity Planning and Review of Existing Arrangements

One important aspect of planning for higher gift and estate taxes, as well as other tax changes, is reviewing whether there will be sufficient liquidity to pay the tax. Liquidity planning can include: obtaining additional life insurance, usually using an irrevocable life insurance trust; selling illiquid assets or planning for a potential sale; and, borrowing or increasing access to credit. Liquidity planning may be the best way to act in anticipation of tax increases, as it should help no matter what form the tax increases take.

One final point—there also has been considerable discussion of increasing resources for the IRS and targeting wealthier individuals for audits. It is always a good idea to review the planning completed to date in order to make sure it has been implemented properly and resolve any issues ahead of any potential review by the IRS. For instance, did you send your annual Crummey notices to your trust beneficiaries? Are payments current on any intra-family loans? Are you paying market rent on residential real estate you are using if it is owned by an irrevocable trust?

With all these potential changes on the horizon, it would be a good idea to contact your Day Pitney estate planning attorney with any questions you may have and to review potential avenues for further estate planning.