October 29, 2020

Generations Fall 2020 - Estate Tax Policy Outlook: Potential Tax Policy Impact of the 2020 Election

At Day Pitney's Palm Beach Family Office Forum, Day Pitney partner Daniel L. Gottfried moderated a panel providing insights with respect to possible federal tax policy changes in light of the upcoming presidential election.

There was general agreement that the election will have a key impact on tax policy, as a Democratic sweep could mean broader tax policy changes that could result in tax increases. Julio Castro, a partner at Evercore Wealth Management, noted that, even with a Trump victory, estate tax repeal is not likely in the near future because of the growing federal deficit, which has been magnified by the government's COVID-19 response. In the event of a Trump victory, we may see more revenue generation legislation, like the recent SECURE Act which impacted retirement plans, even if there are no tax rate increases, as a move to reduce the federal deficit. On the other hand, Vice President Biden has not provided much detail on his plans for the federal estate tax, other than to say that he intends to "return to historic norms." However, his proposal to eliminate the step-up in basis at death for inherited assets would represent a significant departure from historic norms. As far as whether he would do this through triggering a tax on asset appreciation at death or requiring a carried-over tax basis for inherited property remains to be seen.

Under current law, the federal gift and estate tax exemption is $11.58 million in 2020 and is scheduled to increase for inflation each year until the end of 2025, when it will sunset back to $5 million (indexed for inflation). Vice President Biden has indicated he will completely or partially repeal President Trump's 2017 tax cuts, and this could mean accelerating the sunset of the exemption, possibly to 2021. Alternatively, this could mean reducing the federal estate tax exemption to $3.5 million and the gift tax exemption to $1 million, levels that were in effect during President Obama's first term.

Because of the uncertainty as to what may happen with the federal gift and estate tax exemptions in 2021 and beyond, many families are looking to make major gifts before the end of the year, in order to use exemption amounts that might otherwise be lost in the event of a Democratic sweep. Transactions entered into in 2020 are likely to be "safe" under the anti-clawback rules, meaning that any retroactive changes in tax legislation must be "modest" in order to be constitutional. Most observers believe this means that significant changes to these laws made after 2020 cannot be effective earlier than the beginning of 2021.

In order to gain the benefit of the increased exemption amount, gifts must be made in excess of the anticipated reduced exemption amount. Thus, if you expect that the exemption amount will be reduced to $5 million, you must make gifts in 2020 that will put your lifetime gifts above $5 million in order to use that excess exemption. (Residents of Connecticut need to be aware that Connecticut has its own gift tax, with a significantly lower exemption amount.) Because of the size of these potential gifts in 2020, a donor should carefully consider the options and ensure that he or she will not have need for those funds after making the gift. Married donors might consider establishing a spousal lifetime access trust, or "SLAT," to receive a significant gift. In this way, the funds would be available to the donee spouse as a beneficiary of the trust, if needed. Unmarried donors might instead establish a domestic asset protection trust. In this structure, a donor can transfer assets to an irrevocable trust for the donor's benefit and still fully utilize his or her exemption. These trusts require careful structuring and drafting, so it is important to have good legal advice before entering into one of these transactions.

Given historically low interest rates, there are some other estate planning strategies to consider. Intra-family loans can shift appreciation of assets in excess of the federally required minimum interest rate to a beneficiary with no transfer tax cost. In this strategy, a senior family member lends funds to a junior family member (or to a trust for a junior family member's benefit)

in exchange for a promissory note bearing interest at the federally required minimum rate (which can be as low as 0.14 percent for a three-year loan made in October 2020). The junior family member (or trust) re-invests the loan proceeds so that any appreciation in value in excess of the rate of interest on the loan shifts wealth to the junior family member (or trust), free of transfer tax.

Another strategy that benefits from low interest rates is a grantor retained annuity trust, or "GRAT." In this structure, a donor transfers property to a trust that by its terms pays an annuity back to the donor over a period of time, which is a minimum of two years. The annuity can be structured so that the actuarial value of the annuity is equal to the value of the property transferred to the trust, plus interest at the federally required interest rate (0.4 percent for a GRAT funded in October 2020). In this way, the donor makes no taxable gift on funding the GRAT. Any appreciation in excess of that federally required rate will pass to the donor's beneficiaries at the end of the term of the GRAT, without any transfer tax. If the assets in a GRAT appreciate early in the GRAT term, the donor can lock in this appreciation by substituting other assets for assets held by the GRAT on a tax-free basis.

In order to implement any of these planning strategies in 2020, it is important to start sooner rather than later, to have sufficient time to consider and implement the plan.

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