Retroactive Tax Legislation and Gift Planning in 2021

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With a Democratic majority now settled into Washington, estate planners are contemplating the potential impact on the estate and gift tax exemption previously increased by the preceding Republican administration. Whether any changes to the estate and gift tax exemption will be made in the near future remains speculative, but the possibility of retroactive legislation has estate planners on high alert. Many clients made gifts in 2020 in anticipation of the "Blue Wave," and many more will continue to make gifts this year, taking advantage of the current $11,700,000 federal estate and gift tax exemption which is scheduled to sunset on Dec. 31, 2025, under current federal law. What happens if a client made gifts that exceed a retroactive change to the estate and gift tax exemption? With careful planning, clients may be able to take advantage of the current enhanced estate and gift tax exemption and avoid gift tax.

Biden Estate and Gift Tax Proposals

During the 2020 campaign, the Biden administration originally proposed lowering the federal estate and gift tax exemption to $5,000,0000 for individuals ($10,000,000 for married couples), and later proposed to restore the exemption to 2009 levels of $3,500,000 for individuals ($7,000,000 for married couples) for estate taxes and $1,000,000 for gift taxes ($2,000,000 for married couples). The most recent Biden proposal released last fall also includes increasing the top estate and gift tax rate from 40% to 45% and repealing the step-up basis will likely mean that death will be treated as a realization event, thereby triggering tax on unrealized capital gains at death. Capital gains are also proposed to be taxed at an increased ordinary income tax rate of 39.6% for taxpayers with income above $1,000,000.

Retroactive Tax Legislation

Although Democrats control the Senate, that control is effectively a slim majority wielded by the tie-breaking vote from Vice President Kamala Harris. Generally, Senate action requires 60 votes to enact legislation and avoid a filibuster that could otherwise block or delay legislation. Unless the filibuster rules are repealed (albeit unlikely), Republican Senate support for any proposed tax reform legislation will be required.

Tax reform may also be passed through the budget reconciliation process. In a nutshell, the Congressional Budget and Impoundment Control Act of 1974 provides a process that allows Congress to consider legislation regarding revenue and spending in order to "reconcile" certain budget issues of the various congressional committees in connection with adopting an annual budget. Any bills that are considered extraneous to the reconciliation process can be stricken under the so-called "Byrd Rule," or may otherwise be subject to sunset requirements. Only one

reconciliation bill is permitted for each fiscal year, which means that we could potentially see two reconciliation bills in a single calendar year for 2021-one bill for the fiscal year ending Sept. 30, 2021, and a second bill for the fiscal year beginning Oct. 1, 2021. Reconciliation bills only require a simple majority vote, and with Vice President Harris' tie-breaking vote, there is a possibility for at least some tax reform legislation to pass.

If the Democratic Congress manages to pull off a tax legislative win, there is some historical indication that any tax legislation resulting in increased taxes could be retroactively effective to Jan. 1, 2021. Most tax legislation is passed prospectively, with an enactment date in the future or as of the date of enactment. Although there has been retroactive tax legislation in the past, increasing tax rates or curtailing an abuse of the law, more recent retroactive tax legislation decreased taxes.

The growing consensus among practitioners and commentators alike is that retroactive tax legislation, at least with respect to the estate and gift tax, is unlikely in 2021. The Biden administration has already signaled that tax reform is not on the priorities list due to COVID-19 pandemic relief, and climate change and racial equity initiatives. With a slim majority in the Senate and potential contests in the 2022 midterm elections, there may not be sufficient votes to pass estate and gift tax legislation, much less if it were effective retroactively. It is also very unlikely that retroactive estate tax legislation will significantly impact revenue so it may not be politically worth pursuing. Given these circumstances, there is a higher probability that any tax reform legislation may not become effective until at least Jan. 1, 2022.

Planning in the Shadow of Retroactivity

The possibility of retroactive legislation presents planning opportunities for clients who fear a potential reduction in the current estate and gift tax exemptions, as well as risks for those who make transfers now should new legislation become retroactively effective to Jan. 1, 2021.

Let's consider Sharon, a hypothetical married client. Sharon has made no other lifetime gifts and in March 2021 decides to make a gift of $11,700,000. Under current IRS regulations, Sharon's use of her lifetime gift exemption is not subject to "claw-back" by the IRS if the exemption is reduced in 2026. If, however, in May 2021, Congress decreases the gift exemption to $1,000,000 retroactively effective Jan. 1, 2021, Sharon may have made a gift of $10,700,000! In this wild scenario, there are a few strategies that could help Sharon "undo" the gift to avoid these significant unintended tax consequences. Some of these strategies include: (1) the use of disclaimers, (2) formula gifts, and (3) transfers to certain trusts.

Disclaimers

One way to avoid triggering unintended gift taxes is for the donee to disclaim Sharon's gift. The donee cannot accept the gift (or any benefit therefrom) and any disclaimer must be made within nine months of the gift to meet the IRS qualified disclaimer rules (unless the donee is a minor). Under New Jersey law, unless the gift instrument provides otherwise, the disclaiming donee is treated as never having received the disclaimed interest. N.J.S.A. 3B:9-8. The gift instrument should dictate distribution of the gift if disclaimed (i.e., to Sharon's spouse, charity, or reversion to Sharon).

If Sharon gifts assets to a trust, the trust instrument should include a provision that authorizes the trustee to disclaim all or any portion of the gift, and provide that the property revert to Sharon. Fiduciaries are permitted to disclaim under New Jersey law without court authorization if the trust instrument expressly authorizes the fiduciary to disclaim. N.J.S.A. 3B:9-4(c). The trust instrument should also provide that any disclaimer by the trustee will not be considered a breach of fiduciary duty. In determining the amount to disclaim, the trustee could execute a formula disclaimer using a defined value clause discussed in Wancky v. Commit; T.C. Memo 2012-88 (an amount, as finally determined for gift tax purposes, that does not exceed $X or an amount that will not result in gift tax). Alternatively, all of the trust beneficiaries can disclaim their interests in the trust (with care taken to preclude the need for disclaimer on behalf of a minor), and the trust instrument should provide that disclaimed property is distributed to charity, Sharon's spouse, or reverts to Sharon.

Formula Gifts

Sharon may also make a gift by assignment using a Wandry-like defined value formula of an amount that does not exceed her available gift exemption (taking into account future legislative changes), or a fractional share (the numerator of which is Sharon's available gift exemption on the date of the gift and the denominator of which is the value of the gift, as finally determined for gift tax purposes). The amount in excess of the available exemption is then distributed to a nontaxable donee, such as charity or to a QTIPable trust for Sharon's spouse, while the exemption amount is distributed to a taxable donee, such as a child.

SLATs, QTIPs and IDGTs

SLATs (Spousal Lifetime Access Trusts) have become popular estate planning vehicles in the age of large gift exemptions. Sharon may transfer assets to a SLAT for the benefit of her spouse and descendants, and her spouse can also transfer assets to another SLAT for Sharon's benefit, thereby utilizing both of their lifetime exemptions. To avoid the reciprocal trust doctrine, the timing of these trusts should be considered, and the drafter should vary the distribution standards, powers of appointment, beneficiaries, and the trustees.

Sharon could instead gift assets an inter vivos QTIPable trust if she is comfortable with her spouse being the only beneficiary. Sharon has until Oct. 15, 2022 (the due date of her extended gift tax return) to make a QTIP election for the trust qualifying the gift for the marital deduction. If the exemption is not retroactively reduced, Sharon will not make a QTIP election. Using a formula QTIP (similar to a defined value clause) may also limit the amount of the taxable gift.

Another option is for Sharon to sell assets to an IDGT (Intentionally Defective Grantor Trust) in exchange for a note and make a small gift to the trust of at least 10% of the sale price. If legislation does not retroactively change, Sharon can forgive the note, which would then be a completed gift. This method works best with flow-through entity assets (S-corporation or LLC interests) because income is reportable by Sharon as the grantor, and the distributions from the entity to the trust can be used to satisfy the note. However, if Sharon dies while the note is outstanding, the trust may be includable in her estate as a retained income interest.

Should Sharon decide to make any gifts in 2021 before the legislative agenda becomes clearer, there are some tools at Sharon's disposal now that could effectively undo gifts that may otherwise result in costly gift taxes.

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