# ESTATE TAX PLANNING IN 2021: UNCERTAINTY ABOUNDS BUT OPTIONS STILL EXIST

Currently, U.S. citizens and non-U.S. citizens living in the U.S. are entitled to an $11.7 million gift and estate tax exemption and are subject to a maximum marginal gift and estate tax rate of 40%. And while the gift and estate tax exemption is scheduled to drop down approximately one-half the current amount on January 1, 2026, there are tax proposals in play that could change the estate and gift tax laws much sooner.

**What are the proposals?**

On the campaign trail, then-candidate Biden expressed a desire to reduce the gift and estate tax exemption from $11.7 million to $3.5 million and increase the gift and estate tax rate from 40% to 45%. The Green Book, recently released by the Treasury, reveals that the Biden Administration also would like to substantially increase the types of transfers that would trigger capital gains for income tax purposes (potentially at proposed higher capital gains rates). The expanded category of transfers would include:

- Gifts
- Death
- Transfers to or distributions from trusts
- Contributions to or distributions from partnerships
- Deemed dispositions from holding assets for 90 years within a partnership or trust

Given that these types of transfers are largely used in current estate planning practices, the Biden proposals along with additional bills that have been introduced in Congress would substantially change today's estate planning environment. Some of the proposed bills recommend enacting tax law changes retroactively. While not normally done, Congress does have the authority to make retroactive changes to the tax law.

**What Can You Do Now?**

In 2020, many wealthy taxpayers implemented planning to take advantage of current gift and estate tax laws, anticipating the possibility that substantial changes were coming as early as January 1, 2021 and that the changes would impact their ability to do meaningful planning going forward. Now the potential risk facing taxpayers who have not yet acted on such planning is whether new tax laws will be enacted retroactively, causing what would have been a tax-free gift to be a taxable gift.

For example, suppose a taxpayer made an $11.7 million gift on August 1, 2021. Then, the gift and estate tax exemption is lowered from $11.7 million to $3.5 million with the gift and estate tax rate increased from 40% to 45%, all retroactively effective January 1, 2021. What was considered a tax-free gift on August 1, 2021 now becomes a taxable gift and incurs gift tax of $3,690,000. If both spouses made equal gifts of $11.7 million on August 1, 2021, the total gift tax would be $7,380,000. Taxpayers who are considering substantial gifts or similar planning today need to carefully consider the possibility of retroactive changes in the tax laws.

**Gifts to Next Generation – in Trust or Outright**

For those taxpayers willing to engage in estate planning, one planning technique is making gifts to trust(s) for the benefit of children and grandchildren. Under current rules, a married couple that has made no prior taxable gifts can transfer up to $23.4 million without incurring gift tax. The gift often consists of cash, marketable securities or closely held business interests. A gift of closely held business interests generally attracts valuation discounts for lack of control and lack of marketability, as determined by an appraisal.

Alternatively, individuals can make an outright gift to their child who has reached the age of majority. Legal counsel, however, often recommends gifting to a trust because a trust may offer creditor protection, divorce protection and protection from future gift, estate and generation skipping taxes.

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**Spousal Lifetime Access Trust**

Some taxpayers are uncomfortable transferring large amounts to trusts for their children, or they are concerned about the complete loss of control of the assets. In response to these concerns, a "spousal lifetime access trust" (SLAT) may be appropriate. A SLAT is created when one spouse (the donor spouse) funds an irrevocable trust for the benefit of the other spouse (the donee spouse). Normally, the donee spouse, children and grandchildren are named as discretionary beneficiaries of the SLAT, with the trustee making distributions to the donee spouse, as deemed appropriate.

A SLAT typically will be a grantor trust for income tax purposes, causing the donor spouse to pay the income tax on the income earned by the trust. Assets owned jointly by both spouses cannot be used to fund a SLAT. Careful trust drafting is required to minimize issues that can arise if the donee spouse dies or the spouses divorce. When a husband sets up a SLAT for his wife and children and the wife sets up a SLAT for her husband and children, the terms of the two SLATs should not be identical to avoid the "reciprocal trust doctrine." If the trusts run afoul of this doctrine, the trusts essentially are unraveled, negating the intended planning.

**Grantor Retained Annuity Trust**

Another common estate planning technique used by wealthy individuals is the "grantor retained annuity trust" (GRAT). Gifts to a GRAT are designed to use little or none of the individual's lifetime estate and gift tax exemption. Instead, the objective of a GRAT is to shift future income and appreciation on the trust assets to the next generation. The GRAT works best if the individual has assets that are expected to grow in value above what is known as the Section 7520 rate, which is set each month by the IRS. The rate for July 2021 was 1.2%.

For example, suppose a GRAT was established with $10 million of assets in July 2021 for a term of five years and was expected to earn 8% over the five-year term. Under this fact pattern, approximately $2.5 million would pass tax-free to the next generation outright or to a trust for the next generation, using little to none of the individual's gift and estate tax exemption. Taxpayers should consider having a GRAT in place—especially under current tax law—if their goal is to transfer assets to the next generation.

**Final Thoughts**

Given the uncertainty of whether tax changes will be enacted and as of when, individuals who have not recently updated their estate plans should consult with their estate and tax advisor, sooner rather than later. Your advisor can assist you in assessing and evaluating your family goals and objectives as to wealth succession and create an estate plan that considers current and future risks, whether legislative, financial or otherwise.