

Defensive Planning for Proposed Tax Increases

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In 2021, the news has been full of reports of proposed tax increases contained in bills submitted to Congress under the Biden Administration. Whether these bills will be approved is uncertain as of this writing (July 30, 2021). With so much legislation making its way through Congress, the time may be right to start thinking about how to play defense against potential tax hikes. Although details of the proposed increases could change before any bill is enacted, it's wise to have an asset protection plan ready.

How might you defend against tax increases proposed by the bills currently gaining traction in Congress? The strategies discussed below encompass estate planning, contingent planning, and income tax planning that may be beneficial. As more details about the bills before Congress emerge, we can reassess and refine your plan for addressing tax changes ahead.

Estate Planning Strategies

The trusts discussed below focus on defending against a reduction in lifetime federal estate tax exemption, which is currently \$11.7 million per person. Many people are wondering if they will be able to use this large exemption in 2021. But an immediate reduction is not part of President Biden's proposals in the American Jobs Plan or American Families Plan, two of the bills currently under consideration by Congress. Another bill, the 99.5 Percent Act, *does* include gift and estate tax changes but does not attempt to make these changes retroactive.

The IRS confirmed that if taxpayers properly use gift and estate tax exemption during years with a higher threshold, [they will not be penalized if they die when the exemption is lower](#). Accordingly, taxpayers should be able to make use of the \$11.7 million estate tax exemption in 2021.

Grantor trusts. Grantor trusts can offer a straightforward way to trigger the current federal gift and estate tax exemption while still keeping assets "in the family." An irrevocable trust is often set up to benefit children while reserving certain powers that allow the trust to be taxed to the grantor for income tax purposes. This provides the multifaceted advantage of removing assets from the client's estate while helping to safeguard the growth of those assets from the annual tax burden. Plus, payment of the taxes by the grantor is not treated as an additional gift even though it is an added benefit to the beneficiaries.

The 99.5 Percent Act—proposed by Sen. Bernie Sanders—and the Sensible Taxation and Equity Promotion (STEP) Act—proposed by Sen. Chris Van Hollen—would significantly curtail the benefits of these estate planning vehicles. As proposed, funding a grantor trust would not remove assets from the grantor's estate and would trigger a capital gains realization event. The bills appear to grandfather grantor trusts that exist before the effective date of the enacted legislation.

If you would like to add this component to your estate plan, consider creating and nominally funding such a trust as soon as possible. Additional funding could later be arranged as the final legislation becomes clearer, or assets funded into the trust could later be exchanged for other property. Of course, as with any estate planning decision, it's important to consult with a qualified attorney when deciding the right course of action for you.

SLATs and ILITs. Spousal lifetime access trusts (SLATs) and irrevocable life insurance trusts (ILITs) focus on combining wealth transfer tactics with leveraging and protecting estate values. Typically, both types of trusts own large life insurance policies and periodically receive gifts from the grantor to cover the equally large premium payments. These contributions can be structured as larger gifts that use up the lifetime estate tax exemption (\$11.7 million in 2021) or the annual gift tax exclusion (\$15,000 in 2021).

SLATs are designed to allow a non-grantor spouse to access and benefit from built-up cash values in life insurance policies. Both SLATs and ILITs provide income-tax-free death benefits since the benefit is paid outside of the grantor's estate. In some very large estates, these death benefits might help protect other assets by providing liquidity to pay estate taxes.

The impact of congressional bills on these trusts could be very dramatic. For one thing, SLATs and ILITs are typically grantor trusts and the issues discussed above would apply. While the trusts might be grandfathered, the proposed laws would apply to any new contributions—which may pose a problem because regular contributions occur by design for many of these trusts.

To plan ahead, one option that may be worth considering is to prefund these trusts to allow the trustee to pay up the policy, a strategy that would use the estate tax exemption this year while the threshold is high. It would also appear likely to fully grandfather the trust for the future.

GRATs and FLPs. Grantor-retained annuity trusts (GRATs) and family limited partnerships (FLPs) are very common estate freeze tactics. They let grantors remove future growth from their estate while still potentially receiving some ongoing benefits from the assets. Both GRATs and FLPs can be designed to use little or no estate transfer tax exemption.

The 99.5 Percent Act explicitly targets GRATs—it mandates that GRATs must be more than 10 years in duration and leave at least the greater of 25 percent of the market value or \$500,000 to the remainder interest. This could eliminate the common strategy of using GRATs in short, rolling increments. Therefore, 2021 might be the final year to move significant cash or highly appreciable securities out of a grantor's estate.

Likewise, the 99.5 Percent Act introduces limitations to discount valuation rules—most notably targeting entities such as FLPs and limited liability companies by preventing a discount in cases where any family member continues to control the transferred entity. It would eliminate the longstanding practice of methodically transferring FLP interests to the next generation using annual valuations at minority and marketability discounts.

As with ILITs, transferring large portions of a FLP in 2021 if you still have large exemptions to use this year may be worth considering and discussing with your attorney or tax professional. You should be aware, however, that the 99.5 Percent Act could eliminate the attractiveness of future FLPs.

Contingent Planning

Given the uncertainty regarding congressional approval of tax changes, consider creating contingent gifts and trusts through a variety of legal mechanisms. For instance, in the case of gifts to trusts for spouses, it's possible to create a lifetime qualified terminable interest property (QTIP) trust. Since a QTIP election is due at the same time as your personal income tax return, this approach allows time to see what legislation gets passed in 2021.

If no significant changes occur, you can decline to file the QTIP election with your tax return in 2022. Depending on how you had the attorney draft your trust, this decision would most likely bypass your spouse and fund a trust for descendants, using any future increases in the gift and estate tax exemption.

Similarly, trusts can grant helpful options and powers while we await the outcome of 2021 legislation. One such option allows the power holder to exercise a disclaimer and send assets back to the grantor of a trust. Since qualified disclaimers must be made within nine months of disclaimable interest creation, a power holder could wait until 2022 to make this decision.

Income Tax Planning

One of the potentially consequential bills before Congress, the American Families Plan, would add a 39.6 percent capital gains bracket and eliminate the stepped-up basis at death for estate gains of more than \$1 million. In another restrictive proposal, the STEP Act would institute regular mark-to-market recognition for capital gains. The proposal provides two main instances where a previously tax-free event would result in the recognition of capital gains: standard gift transfers to family members or most irrevocable trusts and every 21 years during the lifespan of any non-grantor trusts.

To help defend against these proposals, having steady and predictable yearly income could be beneficial. Your goal would be to stay within a preferred tax bracket and prevent triggering the top income tax rates in any given year. The use of charitable trusts and donor-advised funds are two planning vehicles that allow you to “dispose” of income in a given year and remain in a particular tax bracket. These proposals would also make regular recognition of gains, likely in connection with tax-loss harvesting, to keep total unrealized gains in check more prudent.

If you're a business owner looking to sell, you'll want to discuss with a qualified attorney or tax professional strategies to avoid a large one-year spike in income (which often occurs with the sale of a business). An installment sale is one way to structure a sale so that the seller recognizes only a portion of the entire sale each year for several years.

Concerns About Retroactive Tax Increases

Another notable concern is whether the effective date of a tax change will be retroactive, which would wipe out taxpayers' ability to plan around a law before the year ends. The Biden Administration's current budget proposal assumes the increased capital gains bracket would be made retroactive to earlier in the year. While that does not necessarily mean retroactivity will become law, the income tax planning strategies noted above could come into play in late 2021 if it does.

Need Additional Information?

Just months into the Biden Administration, we're still in the very early stages of the legislative negotiation process for bills currently proposing tax changes. While there has been some progress—such as the apparent infrastructure deal—Congress is still very far away from any final legislation. So, although it's wise to start thinking about or implementing defensive strategies, you should carefully consider your risk tolerance first and work with your attorney or tax professional for help navigating your situation. An attorney's assistance can also ensure that defensive planning strategies are up to date with both federal and state tax codes and new laws. I'm happy to assist in evaluating any specific situations or concerns, so feel free to reach out to me or my office at any time.

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