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How to Prepare For Future (Or Past) Tax Law Changes

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Changes to the federal tax laws could be coming as soon as January 1....2021. You read that correctly. There are currently three major proposals to change federal income and transfer tax laws, one of which would tax transfers retroactively to January 1 of this year:

The "For The 99.5 Percent Act," introduced by Senator Bernie Sanders, focuses on transfer taxes and would reduce the current estate, gift, and generation-skipping transfer (GST) tax exemptions. In place of the current combined gift and estate tax exemption of \$11.7 million (\$10 million, adjusted for inflation), along with a GST exemption of an equal amount, the estate and GST tax exemptions would be reduced to \$3.5 million (not to be adjusted for inflation) and the gift tax exemption would be even further reduced to \$1 million. Transfer tax rates would also be increased by replacing the current flat rate of 40% with a progressive rate system, which would include rates ranging from 45% to 65%. Other major changes would limit a donor's ability to take discounts in valuing certain assets; restrict the use of GRATs (grantor retained annuity trusts); radically change the treatment of grantor trusts (the income of which is currently taxed directly to the donor during the donor's lifetime instead of to the trust); limit the ability to leverage generation-skipping planning; and significantly limit the options for making annual exclusion gifts. The effective date of rate and exemption changes would be January 1, 2022, but many of the other changes would be effective at the date of enactment.

The most notable change proposed by the "Sensible Taxation and Equity Promotion (STEP) Act" would eliminate the current step-up in basis, which allows the recipient of an asset to utilize the fair market value of an asset as of a donor's date of death as the basis of the asset for income tax purposes. Instead, the STEP Act legislation would treat transfers of appreciated assets at death as realization events for capital gains tax purposes and would similarly treat lifetime transfers to and from trusts as if they were sales subject to capital gains tax (with certain exemptions, such as for transfers to trusts for spouses or charity). The proposed effective date of this legislation is January 1, 2021.

Thus, any transfer made this year prior to the date of enactment could be subject to these rules. Similar legislation introduced into the House of Representatives carries a proposed effective date of January 1, 2022.

The Biden Administration's "American Families Plan" tax proposals ("Administration Proposal") focuses on the treatment of capital gains. In addition to increasing capital gains tax rates for individuals with adjusted gross income in excess of \$1 million, the "Greenbook" description of the Administration Proposal includes changes similar to those proposed in the STEP Act. However, in certain respects, these changes would be more extensive because they would treat transfers not only to trusts, but also to partnerships and other non-corporate entities, as sales. Other than its proposals regarding tax rates, the Administration Proposal would generally be effective January 1, 2022.

The STEP Act and the Administration Proposal represent dramatic changes that would effectively create a new capital gains tax on transfers of appreciated property. However, neither the Administration Proposal nor the STEP Act, include changes to the current gift, estate, or GST tax exemption or rates, or many of the other proposed transfer tax amendments included in the For The 99.5 Percent Act. Statements offered in connection with the issuance of the Administration Proposal indicate that the Biden Administration believes the changes effected by its proposal would be so significant that alterations to the transfer tax regime, such as those proposed by the For The 99.5 Percent Act, would not be necessary or appropriate.

Any increase in anticipated tax burdens will influence future planning, but, notably, the unique nature of some of the current proposals could also significantly affect the treatment of prior wealth transfers. This could include not only the retroactive application of tax to gift transactions completed in 2021 prior to the date of enactment, as proposed by the STEP Act, but also the possible imposition of capital gains tax on trusts (and in the case of the Administration proposal, partnerships and other non-corporate entities) that own property that has not been the subject of a recognition event, like a sale, for at least 21 years (in the case of the STEP Act) or, alternatively, 90 years (in the case of the Administration Proposal). Such application could have far-reaching implications for trusts and other entities created many decades ago (because the testing period begins January 1, 1940 in the case of the Administration Proposal), and/or the imposition of significant limitations that might affect existing trusts that are part of a long-term gifting program.

Unlike many prior changes to the law in this area, the proposed legislation will not just affect planning for ultra-high net worth clients. These changes could result in the imposition of tax on, and impact lifetime gifting and estate planning for, clients across the wealth spectrum.

For a variety of reasons, many clients are currently interested gifting and/or the creation of trusts for family. Specifically, many clients are considering such planning in order to transfer their wealth in a tax-efficient manner to their family members – for example, by means of gifts intended to “lock in” the current high exemption levels before they are reduced (which, without passage of new legislation, will occur on January 1, 2026). However, Congress is only now beginning the process of considering the budgetary proposals that would include these tax changes and that process is likely to extend into the fall. Given the uncertainty with respect to any final legislation, as well as the unique nature of each individual's estate plan, there is no “one size fits all” solution to avoid the possible implications of the proposed tax legislation. For this reason, clients who are interested in considering gifts and transfers to trusts and other tax sensitive planning should contact their Vorys estate planning attorney to learn which potential changes to the tax law they

should monitor for purposes of their individual plan and whether any prior plan to make one or more gifts should be re-evaluated.