Estate Planning Ramifications of a Democratic Sweep

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On January 5, 2021, Georgia Democrats Jon Ossoff and Raphael Warnock defeated GOP incumbents David Perdue and Kelly Loeffler in their Senate runoff elections, giving the Democrats 50 seats in the Senate. Vice President Kamala Harris has the power to break a 50-50 tie, which gives the Democrats effective control over the Presidency, the Senate, and the House.

Below is a summary of potential tax law changes as a result of the Democratic sweep, along with strategies that taxpayers may consider implementing in case these tax law changes materialize. This discussion supplements our previous alert published on October 19, 2020 (available here), now that the election results are final.

Potential Tax Law Changes

Below is a non-exhaustive list of potential tax law changes under a Democratic administration:

- Lower Transfer Tax Exemptions – Under current law, the estate, gift, and generation-skipping transfer (GST) tax exemptions are each $11.7 million per person, or $23.4 million per married couple. These large transfer tax exemptions are indexed for inflation through 2025. In 2026, however, the exemptions are scheduled to drop to $5 million per person, or $10 million per married couple, again indexed for inflation. Most pundits believe that Biden would attempt to reduce the transfer tax exemptions to $3.5 million per person, or perhaps even lower, before their scheduled sunset in 2026.
- Higher Transfer Tax Rates – The current tax rate for transfers in excess of a taxpayer's estate, gift, or GST exemption is 40%. In addition to lowering the exemption amount, the transfer tax rate could also increase, perhaps to 45% or higher.
- No Income Tax Basis Adjustment at Death – Currently, most assets that pass through a deceased taxpayer's estate receive an income tax basis adjustment, either up or down, to fair market value at the taxpayer's date of death. This can be extremely beneficial for highly appreciated assets, such as low-basis securities, or a closely held business, as it wipes out all pre-death capital gain on the asset. Biden has proposed eliminating this basis "step-up" at death, which could result in substantially higher capital gains taxes on inherited assets.
- Taxation of Capital Gains at Ordinary Income Tax Rates – Long-term capital gains are currently taxed at a top rate of 20%. Biden has proposed taxing capital gains at ordinary income tax rates, meaning that the new top rate could be 39.6%, or potentially higher.
- Elimination of Other Popular Estate Planning Tools – The Democrats may also dust off old transfer tax proposals last seen during the Obama administration. For example, they could seek to eliminate short-term grantor retained annuity trusts (GRATs), restrict the use of valuation discounts, impose a term limit on GST trusts, and/or limit the use of grantor trusts in estate planning transactions.

If the transfer tax laws do change, it is fair to ask when these changes will take effect. It is also fair to ask whether such changes could be made retroactive from the date of enactment. While there is no guarantee, it seems unlikely that any tax laws will be made retroactive to January 1, 2021. It seems more likely that tax law changes would be effective upon the date of enactment, or perhaps January 1, 2022, if tax legislation is pushed to the third or fourth quarters of 2021. No one can predict the future, however, and strategies may be available to reduce the risk of retroactive gift tax.

Planning Considerations

- Use "Bonus" Exemptions Before They Expire – If the transfer tax exemptions are decreased, either under the new administration or in 2026, taxpayers will face a "use it or lose it" scenario. In other words, taxpayers must use their "bonus" exemptions before they go away, or risk losing them forever. If a taxpayer elects to use his or her bonus exemption in 2021, the IRS has stated that there should not be a "claw back" if the exemption is decreased in 2021 or future years. Consequently, taxpayers who may have a taxable estate should consider utilizing their bonus exemptions while they still can.

- Use Popular Planning Tools Before They Are Eliminated – As stated above, it is possible that many popular estate planning tools, such as valuation discounts, GRATs, and other grantor trust techniques, may be eliminated or at least heavily restricted. Taxpayers who have been considering these strategies should consider implementing them now before any potential changes in the tax laws.
- Take Advantage of Low Interest Rates and Depressed Asset Values – In many cases, wealth transfer planning works best when interests rates are low and asset values are depressed. Applicable federal rates (“AFRs”) are at or near historic lows, and many businesses have suffered severe economic losses as a result of the COVID-19 pandemic. In January 2021, the short-term AFR (for loans less than 3 years) is just 0.14, the mid-term AFR (for loans between 3 and 9 years) is 0.52%, and the long-term AFR (for loans more than 9 years) is only 1.35%. The 7520 rate, which is used for GRATs and other strategies, is near all-time low at 0.6%. These historically low rates certainly benefit new transactions, but also present an opportunity to enhance existing transactions by renegotiating lower interest rates for existing promissory notes.
- Build In Potential Access to Transferred Funds – Some taxpayers cannot afford to give away their full bonus exemptions, but could face significant transfer tax liabilities if the exemptions are lowered. For example, consider a married couple with a net worth of $20 million. This couple does not have a taxable estate today, but could owe substantial estate tax at the surviving spouse’s death if the laws change. To avoid giving away all of their assets, these taxpayers may need to “have their cake and eat it too” by implementing a strategy that utilizes the bonus exemptions before they expire, but allows potential access to transferred funds if they are needed in the future. For married couples, spousal lifetime access trusts (SLATs) continue to be viable planning tools. For single taxpayers, there are other strategies available to build in potential access to gifted property. Each taxpayer’s situation is different, of course, and our group has prepared a white paper discussing potential gifting strategies, which we would be happy to share upon request.
- Consider Accelerating Capital Gains – We typically do not recommend selling a business or harvesting capital gains just because the tax rates could change. Taxpayers with pending sales, however, may consider finalizing those sales in early 2021 to take advantage of the 20% capital gains rate, just in case the tax laws change later in the year.
- Have the Conversation Now – Waiting until the last minute to implement an estate planning transaction is usually not a good idea, and it could be a particularly bad idea in 2021. We may have very little notice before potential tax law changes become effective, and many professionals are anticipating heavy caseloads in 2021. The time for having these conversations is now, so that taxpayers are not caught flat-footed if and when tax legislation is passed.

Conclusion

Although the tax landscape could change significantly in the coming months, we certainly encourage everyone to “look before they leap.” To that end, it is important to recognize that each person’s situation is unique and requires individualized analysis and advice.

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