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Worth It Episode 5: Tax Matters - An Overview Of The Proposed Changes To Federal Transfer Tax Law

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In this episode of Worth It, Proskauer partner and head of the firm's Private Client Services Group David Pratt and associate Daniel W. Hatten discuss the recent bills introduced in Congress which could dramatically alter federal transfer taxes, how those changes could affect clients, and what steps clients can take in the interim.

Dan Hatten: Hello and welcome to Worth It, a podcast brought to you by Proskauer’s Private Client Services Group, covering a wide range of topics concerning estate planning, wealth transfers, and important legal developments and other issues our clients frequently face when organizing their estates. My name is Dan Hatten, associate in Proskauer’s New York office. In this episode, we'll be discussing the recent bills introduced in Congress that could dramatically alter federal transfer taxes, how those changes could affect our clients, and what steps clients should consider taking today. Joining me for this episode is David Pratt, partner in Proskauer’s Boca Raton office and head of the firm's Private Client Services Group. Welcome, David.

David Pratt: Thanks so much, Dan. Glad to do this.

Dan Hatten: Thanks for joining today. So before we get into these new bills, I think it might be helpful to get a high level overview of the transfer tax system in the U.S. today before these bills are even being considered.

David Pratt: Sure happy to. So our system of estate, gift and generation skipping transfer taxes is the transfer tax system. And essentially, there are three taxes. There's a gift tax that is imposed on gifts made during life. There is an estate tax imposed on the assets that are owned by an individual upon his or her death. And then when a transfer is made to what we would refer to as a skip person - For all intents and purposes, that's a grandchild - then there is another tax imposed, and that's the generation skipping transfer tax. Those are the types of taxes and the rate is a flat 40%. So that's the bad news. The good news is that the Internal Revenue Code gives us a nice exemption for gift and estate tax purposes, we refer to it as the gift and estate tax exemption. For generation skipping tax purposes, we refer to it as the GST tax exemption. And it's very neat today because the exemption is exactly the same for gift and GST purposes or estate and GST purposes. And it is $11.7 million today. I'll add and we'll talk about it I think, a little later in the podcast, that there's a little bit of history there. It really is a $5 million exemption, it was indexed for inflation from 2011 on every year, and then the Trump Tax Act in 2017, essentially doubled it in 2018 to $11,180,000. It's been indexed and now it's up to $11.7 million. So those are the taxes, Dan. That is the exemption. But we need to talk about some ways to exclude assets from that tax base.

First, we talk about the annual gifting exclusion. All of our clients know that they can give a certain amount to as many individuals as they want in any given year. It used to be $10,000, it's been indexed for inflation for many, many years, it is now up to $15,000 or $30,000, if a married couple makes a gift of $30,000 two times the annual exclusion. That's the first gimme, as we like to say. And then of course we have the health care exclusion or the medical exclusion, I should say and the educational exclusion. So when somebody makes payments for somebody else's medical expenses, those are excluded from the tax base. And the same thing holds true for tuition payments for education.

Dan Hatten: So that's all very helpful, and I think sets the stage well. So now that we know what where we're at today, we're here to discuss these bills recently introduced in Congress and how they would change this system and change where taxes are imposed and what those gimmies might be. Can we start with the "For the 99.5% Act"? And can you tell us a little about the changes proposed in this act proposed by Senator Sanders. It’s a bit of a mouthful, so let's just call it the Act for purposes of this conversation.

David Pratt: Sure, happy to Dan. Let me start by saying that the Bernie Sanders Proposal, the Act, as you have said, the 99.5% Act is very, very aggressive. And during last year's campaign, we saw some hints of the far left suggesting these types of changes. I want to be clear that this is just his proposal. We have no idea where this will land. But it does definitely does give us a sense of what the Bernie Sanders of the world and the Elizabeth Warren's of the world are thinking. You may be wondering why are we calling it the 99.5% Act. And the reason is, is that it really only affects the top half percent of wealthy Americans. So this isn't going to be a Tax Act that affects a lot of people. But as you can imagine, because it is coming from Bernie Sanders, who makes no secret that he wants to tax the wealthy, this is aimed at taxing the wealthy. And this bill, if any part of it or all of it were to pass would do two things. First, it would essentially increase the estate, gift, and the generation skipping transfer taxes that would be imposed compared to what the law says today. But equally as important is that it essentially would take away a lot of the tools that we use in our toolbox, so to speak, that us estate planning lawyers have been relying on for many years with our clients in order to effectively reduce their estate taxes.

So let's talk a little bit about what those changes are. First, the exemption I just told you, it's $11.7 million. Well, his Proposal would actually go back to the way the law was in 2009, when the estate tax exemption was $3.5 million. And the gift tax exemption was a million dollars. And this was a disconnect, actually, from 2002 on there was a disconnect between the estate and gift tax exemptions. And essentially, that disconnect would be reinstated. So if somebody made a gift or cumulative gifts in excess of a million dollars, they would be paying tax, whereas for estate tax purposes, it would be $3.5 million. That's the bad news. I guess a little good news is that there is an effective date of January 1, 2022. A lot of us have been concerned about a tax bill coming out in 2021 with retroactive effect to January 1st, this one has an effective date of January 1, 2022, which effectively tells us that we can do some planning. I'm sure we'll be talking about that a little later in the podcast. What about the rate? I told you it was 40%. Well, guess what? Not surprisingly, it's going back up going to 45% under this Bill for cumulative estates between $3.5 and $10 million, then we go up to 50%. For estates between $10 and $50 million, then over $50 and up to a billion we go to a 55% rate. And then 65% for estates over $1 billion. Years ago we had marginal tax rates and a lot of planning can be done for the bigger estates with marginal tax rates. And it looks like if something like this is passed, we'd be going back to that type of planning.

Now, what about that annual exclusion that I told you about? And we all know that we encourage our clients to give $15,000 to as many people as they can in any given year? Gone, it would be gone and replaced essentially with a $30,000 annual exclusion per transferor as opposed to done or the transferee the way it exists under today's system. So $30,000 that's it. But with respect to Crummey Powers, as we know in insurance trusts, essentially this would take away the ability to use Crummey Powers like we know it today.

Dan Hatten: That definitely sounds like a very different tax regime structure but that sounds like a lot of them have a history in the Tax Code. You mentioned the Bill will affect some of the tools that we use as estate planners to help our clients. Are there any of those more particular tools that you know, you want to highlight now?

David Pratt: I do, Dan. Um, we have seen hints in prior legislation legislative proposals in President Obama's budget proposals and in general discussion from the IRS about some techniques that are essentially allowed whether it's by statute or by case law that would go by the wayside. And as I mentioned early on, the tools that we have in our toolbox would be taken away from us. No reason to worry, we will find some other tools that we can use. But it's important to mention the ones that they're discussing now in the context of removing them. The first one is the grantor trust. And as we like to tell our clients, the grantor trust essentially is the gift that keeps on giving. A grantor trust is a trust that is created by an individual, the Settlor, we like to call him or her who makes a gift to a trust that is structured to fall within a certain part of the Internal Revenue Code that essentially says that it is a grantor trust, which means that the Grantor pays all the income taxes on the income earned by the trust. And when the Grantor or the Settlor pays those taxes on behalf of the trust, the payment is not considered a gift. That's why we call it the gift that keeps on giving.

In addition, we very often engage in transactions between the grantor and the trust and because the grantor trust is categorized as such, any of those transactions are just ignored. So we have other transactions that we can enter into that effectively have no tax effect. We can sell assets to a grantor trust for a note and there is no capital gains imposed on the sale because essentially, it's a sale between an individual and himself or herself for tax purposes. Interest payments can be made rent payments can be made. There's a whole litany of ways that we can take advantage of the grantor trust and the fact that they're disregarded for income tax purposes and the assets when gifted to the grantor trust or sold or out of the individual's estate. The bad news here is that all grantor trusts under the proposed legislation that are funded after the Act passes would be included in the grantor's taxable estate for estate tax purposes as if he or she was the owner. Real bad news. Good news existing grantor trust would be grandfathered. And so now I think we're going to start just because of this we're probably we're already doing a lot of grantor trusts for our clients, but I have a feeling we'll be doing a lot more.

Dan Hatten: Yeah anytime something's grandfathered it seems to give an opportunity. And certainly before this is passed or anything like it is passed, this would be a good thing for clients to consider. Are there other tools that might be curtailed?

David Pratt: Yes. Another one of our favorites Dan is the grantor retained annuity trust the GRAT. I believe that we have done a podcast on GRATs. And we like to do these what we refer to as zeroed out GRATs, meaning that you can transfer assets to a GRAT, keep annuity payments and not make a gift. And essentially what happens is you remove all the appreciation of the asset over an assigned hurdle rate that the IRS comes out with every month. We refer to it as the 7520 Rate. In April this month, it's 1%. So to the extent that the rate of return on the assets exceeds 1% over the term of the trust, all of that is removed from the estate. The Proposal says that there will be a minimum term of years, which would be 10 years. And there would have to be a $500,000 value or 25% of the fair market value essentially assigned to the remainder interest. What this means is that they will no longer be a zeroed out GRAT and they will no longer be a short term GRAT. The risks with the GRAT, of course, is mortality. And if the individual dies before the end of the term, the assets come back into the estate with a two year GRAT. We're not so worried with a 10 year GRAT, not so worried with a younger person but somebody who's a little older and has an appreciating asset, he or she would have to survive the term. So GRATs could go by the wayside.

Let's talk about how we value the assets that we gift. Well we know that the value of an asset transferred is the fair market value. What a willing buyer would pay a willing seller neither being under any compulsion to buy and both having reasonable knowledge of the relevant facts. Well, what the case law suggests and the IRS hasn't really frankly figured out a way to beat it, is that valuation discounts can be applied to the value of closely held family entities, whether it's an interest in a limited liability company, whether it's an interest in a partnership or shares in a corporation. There are two types of discounts that are commonly applied, a lack of marketability discount and a minority interest discount. And the IRS has never liked these discounts. We came close to losing them in August of 2016, when the IRS came out with proposed regulations, which would have been the death knell of discount planning. President Trump, of course, in May of 2017 said that there were about 16 or 17 regulatory projects that should be thrown out and this was one of them. But it's back in the form of this, this Bill, or this Proposal where valuation discounts would no longer apply.

Dan Hatten: And so we've talked a lot about the “For the 99.5% Act,” there’s another Act that is currently proposed and being discussed - the “STEP Act” proposed by Senator Warren. How would that affect the current system?

David Pratt: Well, let's first talk about what “STEP” stands for, Dan. STEP stands for Sensible Taxation and Equity Promotion. So it affects I guess, the wealthier as well as I will explain. So President Biden interestingly in his Proposals while he was campaigning did not include any proposal to tinker with the estate and gift tax system. He suggested on a couple of occasions that he would but there was nothing officially pronounced. The one provision that was in his proposals was the elimination of the step up in basis rule that applies at death. Under the existing law, when an individual dies, the basis in all of his assets, goes away, and is replaced with whatever the fair market value is on the date of death. So for example, if you bought, you know, Apple stock, when it was much, much lower, and you died, your new basis would be the fair market value on the date of death. So that if your heirs sold it they would not have any capital gain unless it appreciated since the date of death. Well, this has been, you know, under discussion for quite some time. And it is actually the Canadian system, where death is treated as a realization event for income tax purposes. And you can imagine what happens here with the real estate where a lot of our clients have negative basis in their real estate. And what that means is, is that the only way to eliminate that negative basis goes away. So this is going to be a big issue. My gut tells me that this doesn't get passed, I think it is difficult to administer. There was a time in history when it was passed, or a form of it was passed way back in 1976 and it was repealed before it went into effect. Very, very difficult to administer. I guess the good news is that at least for the smaller estates, there is a $1 million exception, and that will be a deduction, so you don't get hit with a double whammy for any estate tax that would be paid by the individual. Big change!

Dan Hatten: So, like you said, with these big changes, I think it begs the question that a lot of our listeners are probably asking, what should clients be doing now, while these are just proposals?

David Pratt: Well, we continue to do the planning that we were doing at the end of last year to use the $11.7 million exemption. So our clients should, if they haven't already, and a lot of them have, but if they haven't used their estate and gift tax and generation skipping tax exemptions, they should be doing so sooner rather than later. Because it could be a use it or lose it scenario. The gifts that they should be making should be made to grants or trusts that will be or that would be grandfathered under the proposal, whether it's forming a grantor trust and selling assets to it, or lending money, to a grantor trust, try to take advantage before they go away. Dynastic trusts should continue to be used, something we didn't mention was that under the new legislation there would be a 50 year rule that says that the clock resets after 50 years for tax purposes. As we know a lot of people set up these dynasty trusts in jurisdictions that allow trusts to go on forever. Or in Florida, for example, for 360 years, the Internal Revenue Code under the proposal by Bernie Sanders would impose essentially a 50 year termination rule for tax purposes.

So those types of trust should be set up any transfer, whether it's a gift or a sale of Family Health entities, whether it's an LLC partnership or corporation that may attract the discount that I mentioned, the minority interest or lack of marketability, discount, those types of transactions should be consummated while the discounting technique is still allowed. GRATs obviously should be used a zeroed out GRAT, particularly if somebody has an appreciating asset. Annual exclusion gifts should continue to be made, there are ways that we can add a lot of beneficiaries to a trust under existing law. So there's a whole host of techniques that that we may lose, so we should use them before we lose them.

Dan Hatten: I think that's all really helpful, David. Thanks for coming on Worth It and discussing the proposed legislation for The 99.5% Act and the STEP Act. Clearly, if either of these bills passes, or if even one part of these bills passed, it will have a significant effect on the transfer tax laws and the ability for high net worth clients to transition wealth to lower generations. That said, while they still have them, clients should consider using the tools and exemptions available and taking advantage of the planning that we've been doing in the current system. So thanks again.

David Pratt: Thanks, Dan. Thank you so much for putting this together.

Dan Hatten: With that, we'll wrap up this episode of Worth-It. We hope you enjoyed this podcast and please join us for future episodes. If you would like to receive notifications when new episodes are available, please visit our website Proskauer.com and click on the subscribe for publications link at the bottom of any page. Thank you for listening.