Executive Summary

The Biden administration has rolled out its new corporate tax proposals, but we will wait until at least May to see exactly what the administration has in mind for personal income taxes and estate taxes. Meanwhile, the most progressive segment of the Democratic Party has made two proposals that explore the outer boundaries for negotiation as proceedings progress. To be clear, we think it is highly unlikely these proposals will be adopted, even in the more "permissive" circumstances of a reconciliation budget bill. But the bills are a starting point for negotiation and a clear statement by a segment of the Democratic Party of what they hope to accomplish.

Personal income taxes for high-net-worth individuals will almost certainly rise, and there may be substantial changes for estate and gift taxes as well. Individuals who seek to shelter the full $11.7 million estate and gift tax exemption amount will see that window closing soon and should not delay completing their estate and gift planning. Creation of irrevocable trusts to hold the exempted assets, implementation of grantor retained annuity trusts (GRATs) and other tax-effective techniques should proceed with due haste, mindful of the coming changes and of the myriad considerations that must be taken into account when in the midst of unknown legislative change.

The 99.5% Act

On March 25, 2021, Sens. Bernie Sanders, Sheldon Whitehouse, Elizabeth Warren and others proposed the 99.5% Act that would decrease the estate and gift tax exemption amounts to 2009 levels, as advocated by President Biden during his campaign, but would increase estate taxes far in excess of Biden's proposals. In addition, this bill proposes to delegitimize some current taxpayer-favorable estate planning techniques.

Proposed estate and gift tax rates:

- 45% — $3.5 to $10 million
- 50% — $10 to $50 million
- 55% — $50 million to $1 billion
- 65% — over $1 billion

The bill also proposes to:

- Restrict GRATs to a term of no less than 10 years and mandate a taxable gift element for the trust of at least 25% of GRAT assets at inception.
- Strictly limit any valuation discounts which might otherwise be available in valuing gifts or transfer of non-public entities. This would, for example, eliminate the minority discount and the lack of marketability discount commonly available today for valuing partnership and LLC interests.
- Limit annual exclusion gifts so one person could give no more than $20,000 of exclusion gifts per year to a trust, severely impairing the use of "present interest" gifts to fund life insurance trusts and other trusts with beneficiary withdrawal rights. The donor could still give outright gifts of cash of $10,000 each to an unlimited number of persons.
- Limit the Generation-Skipping Transfer Tax exemption to 50 years so that trusts would effectively be taxed every other generation.

The Sensible Taxation and Equity Promotion (STEP) Act

This bill, proposed on March 29, 2021, by Sens. Chris Van Hollen, Sanders, Warren and others, would eliminate the cost basis step-up applied to all assets owned by a decedent at death. The current rule permits inheritors to start with a fresh cost basis after a decedent's death and does not require payment of tax on the unrealized capital gains owned by the decedent a moment before death.

Instead of a step-up, this bill would apply a regime similar to that of Canada — a transfer of an asset by gift or at death is a deemed sale for purposes of capital gains tax. In other words, all unrealized capital gains in a decedent's portfolio would be taxed at his or her death.

The bill has a few exceptions to the "tax at death or transfer" rule:

- $1 million of unrealized gain will be exempt from tax; $100,000 of the exemption may be used on lifetime gifts.
- Transfers to a grantor trust are not taxable transfers if the trust is includible in the grantor's estate; that is, transfers to a revocable trust are exempt from the deemed sale rule.
- Transfers to a spouse or charity, during life or at death, are exempt from the deemed sale rule.
- Unrealized gain of up to $250,000 on a primary residence ($500,000 for a couple) is exempt from capital gains tax.
- The capital gains tax payable on account of an illiquid family business or farm may be paid over a 15-year period.

Harsh on trusts

The bill also has broad and harsh consequences for trusts. All trusts are subject to a deemed sale rule every 21 years. In other words, all unrealized gains accumulated at the end of a 21-year period, measured from the inception of the trust, are subject to capital gains tax. All trusts created before 2005 will have their first deemed realization event in 2026.

Conclusion

We do not think any of the provisions of the bills described above will sail through the Senate, or even the entire Democratic caucus of the Senate. But in this year of transition, it is wise to keep an eye on all the proposals so we can better anticipate what may come down the road and how to plan for it. The implications of the STEP Act, when combined with probable higher capital gains tax later this year or next, are far-reaching and may have consequences for how you analyze what capital gains you realize this year. This is a year to be in close contact with your legal and financial advisors as updates unfold.

If you have questions, don't hesitate to contact your Relationship Management Team.