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BAD MOON RISING: FOR THE 99.5% ACT COULD ELIMINATE OR REDUCE EFFECTIVENESS OF CRITICAL ESTATE-PLANNING TOOLS

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If legislation introduced in the US Senate on March 25, 2021, ultimately passes intact or mostly so, it could introduce the most sweeping changes in federal estate and gift taxation in at least the last 70 years. The proposed legislation would dramatically reduce the estate and generation-skipping tax exemption, the gift tax exemption, eliminate the current step-up in basis in assets at death for income tax purposes, and eliminate significant other estate-planning strategies.

In its current form, the legislation's current and likely effective date is for gifts made and decedents dying after Dec. 31, 2021 – providing the remainder of this year as a planning window. The time is now for individuals having potentially taxable estates under the coming American Jobs Act to review their estate plans and consider incorporating estate tax-reduction techniques that could soon disappear. Additionally, they should work with their estate planner to review how such legislation could affect the continuing efficacy of techniques and estate planning documents such as irrevocable life insurance trusts ("ILITs"), other "grantor trusts," and their revocable trust provisions.

PROPOSED CHANGES

The proposed legislation, which has been termed For The 99.5% Act, incorporating much of President Biden's tax plan, as well as substantial additional revenue enhancement provisions, was recently introduced by Senators Bernie Sanders and Sheldon Whitehouse in the US Senate as a stand-alone tax bill. It incorporates very broad changes in federal estate and gift taxation, including the first actual reduction since its inception in the federal gift and estate tax exemption or its equivalent (hereinafter "estate tax exemption"). A similar bill was introduced by Sen. Sanders last year. The Act – or a majority of its provisions – are almost certain to be melded into President Biden's recently proposed approximately $2 trillion infrastructure plan. The plan was introduced to the public on March 31, 2021, as the Made in America Jobs Act of 2021 as an integral part of its financing, particularly under any "reconciliation process" that would permit its passage by a majority Senate vote outside of a filibuster. The plan provisions with the greatest adverse impact on estate planning include the following:

- Reduction in the estate and generation-skipping tax exemption ("GST") from the current $11.7 million to $3.5 million, indexed annually for inflation, with the portability of unused spousal exemptions to the surviving spouse under current law being retained;
- Reduction in the gift tax exemption to $1.0 million from its current $11.7 million;
- Reduction in the efficacy of using greater retained annuity trusts ("GRATs") to reduce estate taxes;
- No lack of control or lack of marketability discounts in some assets in non-actively traded interests in entities such as LLCs, in which family members have a controlling or majority interest ;
- No such discounts in interests also in any other such entities attributable to marketable securities or passive investment or non-business interests, except for certain "material participation" entities such as real property management companies;
- Existing GST Trust terms limited to 50 years after date of enactment, or the benefits of any GST tax exemption in such trusts are lost, thereafter being subject to an inclusion ratio of 1 for GST purposes, with respect to applicable generation-skipping taxation events thereafter, whereby any such amounts so affected are taxable at the highest applicable estate tax rate;
- New GST trusts created after the Act will have an inclusion ratio of 1 unless they must terminate within 50 years of their creation;
- Benefits of special-use valuation for farms and certain businesses increased from the current $1.18 million valuation reduction to a maximum $3.0 million, perhaps the sole beneficial change, albeit such estates nonetheless still will be subject to a $3.5 million estate tax exemption after such valuation reduction;
- Total loss of the benefits of the current step-up in basis in assets at death for income tax purposes; not currently in the Act, but a Biden proposal certain to be added later;
- Estate tax rates commencing at 45% at $3.5 million of taxable estates and increasing in five percent increments at certain greater valuation levels above such taxable amount to a top rate of 77% for estates over $1.0 billion, as opposed to the current flat 40% rate on estates over the exemption; and
- The assets in so-called "Grantor Trusts" for income tax purposes, the use of which is an effective estate tax-reduction technique utilized by many estate planning attorneys, will now be includible in the estate of the person who contributed assets to it, with distributions therefrom constituting taxable gifts, although such trusts that exist at the time of the Act's effective date are grandfathered.

PUBLIC SUPPORT FOR TAX INCREASES

It is difficult to predict how many of the foregoing estate, gift, and generation-skipping tax provisions in the Act will be retained in the final infrastructure bill to be brought to a vote, let alone others relating strictly to income taxation. However, the Act's reduction of the estate tax exemption, loss of the step-up in income tax basis at death, greatly reduced annual exclusion gifting opportunities, and the substantial reduction in the efficacy of minority and lack of marketability discounts to reduce taxable estates for valuation purposes, and the truncating of grantor trusts and GRATs as viable estate tax reduction techniques would appear to be resistant to any substantial diminution in their import in that process. Such provisions are likely to be submitted as simply closing existing loopholes which allow the wealthy to unfairly avoid or greatly reduce their estate and income taxation.

With Democratic control of the Senate, the weight of the Presidency behind the proposals, and the long-standing desire to have an infrastructure bill which would require revenue increases to fund at least a significant part of the cost to have any reasonable possibility of passage, all estate planners and individuals with larger estates must consider the very real possibility that substantial elements of the Act antithetical to current estate tax reduction techniques may actually pass into law later this year, fundamentally altering the estate tax planning techniques presently available for the worse indefinitely into the future. This perspective is supported by recent opinion polls that have indicated a large segment of the public approves of an infrastructure bill supported by tax increases. This is understandably so if they themselves will remain virtually unaffected by its passage and perhaps buoyed by a

conviction that the wealthy are not currently paying their fair share of the tax burden, and the Act is one way to assist in reversing the so-called wealth gap in the population. That is why the legislation has been labeled For The 99.5% Act, clearly being aimed at only the wealthiest .5% of the population and meant to persuade the 99.5% remainder of the public that they will not incur any substantial adverse tax effects.

PLANNING OPPORTUNITY THIS YEAR

The currently proposed effective date for gifts made and decedents dying after Dec. 31, 2021, is a call to action. Unless its effective date is moved forward in the legislative process, there is clearly a significant "use it or lose it" planning opportunity in the interim for estate planners and individuals who could be adversely affected. The planning opportunity goes beyond simply planning for a reduction in the estate tax exemption. Many people did that late last year and early this year, fearing a possible retroactive reduction in the estate and gift tax exemption, perhaps even back to Jan. 1, 2021, and have already utilized all or most of their remaining estate tax exemption. That circumstance did not occur, albeit there remains a possibility that the effective date of such tax provisions in the American Jobs Act could be changed back to the date of its enactment, rather than their current application on or after Jan. 1, 2022, which Speaker Nancy Pelosi has indicated she wants such passage to occur prior to August of this year.

WHAT LED TO THIS LEGISLATION

For years, indications have been looming that we would eventually be faced with a far less favorable estate tax planning environment:

- Greatly increased federal budget deficits occasioned by federal revenue falling woefully short of discretionary spending by the federal government, despite such discretionary spending having trended downward for many years – some of that gap being attributable to substantial income tax reductions and increased entitlement spending;
- Medicare spending facing a financial crisis within the next decade;
- Social security forecasted in approximately 2033 to have insufficient resources to pay then currently owing benefits;
- Greatly increased expenditures for Medicaid programs;
- A deteriorating infrastructure across the country calling out for federal assistance;
- A pandemic in 2020-2021 that to date, has been met with approximately $6.0 trillion dollars in additional federal expenditures, all unmatched by federal revenues; and
- A federal debt level approaching the national GDP not seen since World War II.

The culmination of these factors have put substantial economic, if not political, pressure on Congress to enhance revenues, i.e., increase taxation. Estate and gift taxes, although they traditionally have not been a substantial portion of federal revenues (typically one percent or less), have always been a symbolic low-hanging fruit in this regard. This is due in large part to a desire to break up large amounts of wealth from being passed from generation to generation, affecting only those that have substantial estates and not impacting affected individuals during their lifetime.

In addition to the recent tax proposals of President Biden, past presidencies have also had various estate and gift tax proposals, including those of President Obama. However, no such proposals were reduced to bills introduced in Congress, until now.

Foulston's estate-planning team will continue to monitor this ongoing legislation, and encourages estate planners and individuals with significant assets to do so as well, in case changes need to be made to update and revise an estate plan before year end.

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FOR MORE INFORMATION

If you have questions or want more information regarding the 99.5% Act, please consult your financial advisor or legal counsel. If you do not have regular counsel for such matters, Foulston Siefkin would welcome the opportunity to work with you to meet your specific planning needs. For more information, please contact **Timothy P. O'Sullivan** at 316.291.9564 tosullivan@fouston.com. For more information, please visit our website at **www.foulston.com**.

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