Insights

Estate and Gift Taxes: Do We Bet on Red or Black (Or Green)?

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Change is coming, again, to the Federal Gift and Estate Tax laws. There are already proposals for increased income tax rates, increased corporate tax rates, increased tax rates on and taxability of multi-national corporations, and proposed increases in the number of employees at the Internal Revenue Service to help with enforcement and collection. There are also several bills, including, but not limited to, the "Ultra-Millionaire Tax Act," the "For the 99.5% Act," and the "STEP Act" which include a variety of potential changes to the taxation of accumulated wealth.

The expected changes include a reduction of the unified credit ("UC"), which would subject "smaller" estates to the Federal Estate Tax ("FET") and an increase to the overall FET rates (increasing the tax due). Some proposals go beyond the expected and include elimination of minority discounts, minimum terms for grantor retained annuity trusts, required terminations (or deemed terminations) of multi-generational trusts and elimination of step-up basis for assets passing at death. All of these are but proposals at this time, however, some aspect of each and combination of them will likely become some form of legislation in the not-too-distant future. With so much pending change, advising clients on wealth transfer planning is akin to advising the client to bet red, black or green on a roulette wheel.

This gambling advice becomes even more of an issue with the "sleeper" provision for an increase in the capital gains tax (CG) rate. One proposal involves increasing that rate to as high as 43.4% (the expected, highest ordinary income tax rate of 39.6% plus a 3.8% tax "kicker" on net investment income). These higher rates become especially important if the tax basis of inherited assets becomes a "carry-over basis" rather than a "step-up basis" to fair market value at death.

An example that brings this chaos into perspective is a current strategy being implemented by many, the spousal lifetime access trust (or "SLAT"). A SLAT is an irrevocable trust for the primary benefit of a spouse and then, at that spouse's death, the children. When the SLAT is funded, the assets transferred to a SLAT are treated as completed gifts to the ultimate beneficiaries. With the continual, likely threat of a reduced UC, many clients have utilized SLATs as a way to use the current UC of $11.7 million before the UC is reduced (there are current proposals that reduce the UC to $3.5 million). To use the higher UC while it is available, clients "bet on red" and implement a SLAT now, guaranteeing use of the credit and avoiding FET on the assets and any future appreciation. The loss of the larger UC alone would result in as much as $8.2 million in additional assets being subject to FET ($3.3 million in additional FET just by not using the higher UC, not to mention FET on the appreciation of those assets). "Betting on red" seems like a real good idea.

However, assets transferred to a SLAT are lifetime gifts resulting in a "carry-over basis" (the assets keep the donor's basis). Again, the benefit of the strategy is to use the UC before it is reduced and avoid FET on the

appreciation of the assets in the SLAT. But if the CG rate goes to 43.4%, we may end up trading higher CG for reduction in FET. So “betting on black,” that is, just holding the assets until death, is another option.

Using simple math, we can show possible results of each bet. Assume we have a client with a large estate, fully taxable at any UC. Then assume that client makes the bet on red and transfers $10 million to a SLAT, with a basis of $5 million. Then assume an increase over the next ten years by 7.2% per year and the client’s death on that tenth anniversary date. The bet on black would be doing nothing different with the $10 million and client dying at the same time. In ten years the $10 million would double to $20 million. If we bet on red, the entire $20 million passes without FET but the eventual CG is $3 million (($20M - $5M) x 0.20%) rather than the $4 million of FET from the gain being taxed in the estate (($2-M - $10M) x 0.40%) (the bet on black). Add to that the additional $2.6 million in FET saved by using UC that dropped to $3.5 million (($10M - $3.5) x 0.40%) and the total tax savings of betting on red could be as much as $3.6 million. If, however, the CG rate increases to 43.8%, the SLAT would result in eventual CG of $6.6 million (($20M - $5M) x 0.438), while the bet on black would result in the same $4 million of FET. Even including the additional $2.6 million saved in FET by using the UC before reduction results in a “break even” result of $6.6 million betting on red or black (which would be like “betting on green”).

The possibility of a significant increase in CG rates greatly affects the benefit of lifetime gift strategies (like the SLAT). Betting on red could be worse than betting on black. The gamble is in implementing a strategy now that could result in a worse, overall tax result. If the client is comfortable waiting to see what proposals in Federal Gift and Estate Tax actually becomes law, that would be best. Most of the changes are proposed with an effective date of January 1, 2022 (but at least one proposal would have the changes effective the date of passage). Clients likely have time to decide whether to utilize strategies like a SLAT until such proposals become law, but taking that time to decide will result in a “robust” end to 2021 for attorneys in the wealth transfer area. Have a good time at the casino, friends.

If you have questions regarding information found in this alert, please contact **Rodney S. Retzner.**