Act Now – Estate Tax Planning Under the Biden Administration

Article
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Over the past twenty years, there has been a dramatic change in the Estate tax laws. Given the Democratic control established in Washington, D.C. this month, additional Estate Tax reform is now a distinct possibility. Currently, each person can give away during lifetime, or distribute at death, an amount of $11.7 million without being subject to federal Estate Tax. That high exemption amount may change under the Biden Administration. Now is the time to speak with your advisor about reducing or eliminating your exposure to Estate Tax.

Current Estate Tax Laws

In 2001, the federal Estate Tax exemption amount [1] – the amount a person can gift during lifetime or transfer at the time of death – without being subject to Estate Tax was $675,000. The top Estate Tax rate was 55%. In 2010, the Estate Tax exemption was drastically increased to $5 million per person, subject to inflation increases, and the Estate Tax rate was dropped to 35%. The tax rate increased to 40% in 2013 and has remained at 40% ever since. Under the Tax Cuts and Jobs Act of 2017, the Estate Tax exemption was doubled to $10 million per person, subject to inflation. In 2021, each person has an exemption of $11,700,000. Due to the sunset of the Tax Cuts and Jobs Act, the exemption amount will drop to $5 million per person in 2026 unless the laws are changed prior to that time. Wisconsin does not have its own state estate tax, but some states do have a state estate, death, or inheritance tax.

Another important aspect to Estate Tax Planning is basis adjustment. When certain assets are included in a deceased person's estate, those assets receive a new tax basis equal to the date of death value. Retirement accounts and annuities are exempt from this rule, and do not currently receive a basis adjustment. For example, assume John Smith paid $50 per share for his 1,000 shares of Apple stock. His original basis is $50,000. Ten years later, John dies, and the 1,000 shares of Apple stock are included in his estate. At the time of his death, the stock is worth $130 per share, for a total of $130,000. If John had sold that stock during his life, he would have been subject to capital gains taxes on $80,000 ($130,000 proceeds – $50,000 basis). However, since the basis in the Apple stock increased to the date of death value, if the beneficiaries of John's estate were to sell the stock, capital gains tax would be paid only on post-death

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Proposed Changes under Biden Administration

The Biden campaign proposed to reduce the Estate Tax exemption amount to $3.5 million per person, and to increase the top rate for the estate tax to 45%. Further, the Biden campaign proposed to eliminate the basis adjustment for assets. It is not clear whether Biden's plan would result in pre-death capital gains being realized, and therefore the capital gains tax paid, at the time of a person's death. Alternatively, if a beneficiary inherits the asset but does not sell it at the time of inheritance, Biden's plan may call for the pre-death appreciation to be preserved until the asset is sold by the beneficiary, and the beneficiary would pay the capital gains tax on both pre-death and post-death gains at the time of sale.[2]

Estate Tax Planning Opportunities

One of the simplest Estate Tax planning techniques is to take advantage of opportunities under the tax rules to make gifts without utilizing your Estate Tax exemption. First, the gift tax annual exclusion allows any person to gift to any other person up to $15,000 each year without utilizing any tax exemption. Further, a person can gift up to 5 years of annual exclusion to create a 529 Account (a specific type of college savings account) without utilizing any Estate Tax exemption. Taking advantage of this rule, a single person could fund a college education account with $75,000 on behalf of a child or grandchild without having to utilize any exemption, and a married couple could fund an account with $150,000.

Second, a person may also pay certain college and medical expenses directly to a third party. For example, a parent can pay a child's college tuition directly to the college, and also make an annual exclusion gift of $15,000 directly to the child in the same year. Over the course of many years, these simple gifting techniques can be very effective at reducing the size of a person's estate, and therefore reducing future exposure to Estate Tax.

Another technique is to make large taxable gifts. Since 2017, when the Estate Tax exemption was doubled, estate planners have advised high net worth individuals to make large taxable gifts to utilize the client's exemption amount. The IRS has confirmed that if a person makes large gifts, and the exemption amount is reduced in a later year to an amount below the value of the previous gifts, those gifts would be grandfathered and no tax would be due. However, there is a possibility that changes to the tax laws in 2021 would be retroactive to January 1, 2021.[3] Given the current environment – both that the exemption is set to decease to $5 million in 2026 and the real possibility that the Biden administration will seek to reduce the exemption sooner and/or to a lower amount – we are currently in a situation where the exemption should be used, or it may be lost. However, large gifts are a high-risk, high-reward planning opportunity. If it appears unlikely that any estate tax laws will be passed this year, there again may be a rush of individuals seeking to make large gifts towards the end of 2021.

My colleague's November 30 article, "**Individual Tax Planning Following the November 2020 Elections"**, covers additional Estate Tax planning opportunities, including the execution of trusts (including those that work well in today's low interest rate environment), and provides additional perspective on income and capital gains taxes.

As a result of possible Estate Tax changes under the Biden administration, individuals should review their current estate plans and work with their advisors on what steps should be taken to reduce or eliminate their exposure to Estate Tax.

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[1] While this article refers to the "Estate Tax" exemption amount, this exemption is a unified exemption that covers both lifetime gifts and transfers at death.
[2] The Biden Administration would likely also seek to lower the Generation-Skipping Tax Exemption, but a discussion of the Generation-Skipping tax is beyond the scope of this article.
[3] There is some precedent in court cases suggesting such a retroactive law lowering exemption amounts is constitutional, but the precise issue of a retroactive law lowering the Estate Tax exemption has not been decided.