Advanced Markets Blog

Planning under the Biden Administration: *"Tax the wealthy!" has become a rallying cry in Congress. How are planners responding?*

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As the country continues to respond to the pandemic and we try to get a clearer vision of what our "new normal" will look like, Congress is turning its attention to an infrastructure bill and considering various tax proposals. The Biden administration has made it clear that improving fairness in the tax code is a priority, as is rewarding work and not wealth.

Some of the tax proposals being discussed in Washington (which you can read about as they evolve in our Central Intelligence updates) include:

- Reducing the current base $10M estate and gift tax exemption (before inflation indexing) to a $3.5M base. This base exemption would technically be the "basic exclusion amount"
- Decoupling federal estate and gift taxes again and imposing a $1M lifetime gift tax exemption
- Increasing the marginal estate and gift tax rate from 40% to 45%
- Limiting the duration of dynasty trusts, the use of short-term GRATs, and certain valuation discounts
- Increasing income (and other) taxes on individuals earning more than $400K in taxable income
- Taxing long-term capital gains and qualified dividends at the ordinary income tax rate of 39.6% on income above $1M
- Eliminating step-up in basis for capital gains taxation, potentially taxing the built-in gain at death
- Increasing the corporate tax rate from 21% to 28% and imposing a global minimum tax on profits from foreign subsidiaries

Since the Democratic Party has only razor thin control of the Senate, it is not clear whether it can get these types of legislative changes to pass. Still, financial professionals and estate planning attorneys are busy helping their clients (1) act now before legislative changes occur and/or (2) put flexible planning structures in place so that clients have the option of acting quickly if legislation appears imminent.

Post-election insurance and wealth-transfer planning opportunities financial professionals are discussing with their clients

1. Outright gifting to irrevocable trusts of remaining gift tax exemption

- Under current law, the federal estate and gift tax exemption is inflation indexed to $11.7M in 2021 ($23.4M for a married couple).
- Some wealthy clients are rushing to use these exemptions now, before legislation lowering them can be considered. Even without intervening legislation, however, many wealthy clients may want to move forward with gifting today in recognition that the base estate and gift tax exemptions will drop from $10M to $5M (before inflation indexing) on 1/1/26 under current law.
- In situations where both spouses will not fully utilize their current exemptions, it may be prudent to consider having one spouse fully utilize his/her lifetime gift tax exemption (rather than gift splitting), so that at least one spouse uses his/her full exemption before the exemption is reduced.

Act now: If gifting is being contemplated, proactively talk to your clients about how life insurance owned by the trust may enhance planning goals by providing an income-tax-free source of liquidity and a favorable internal rate of return on the life insurance death benefit. John Hancock's gifting module can help illustrate the potential benefits of lifetime gifting as well as how to use life insurance inside irrevocable life insurance trusts (ILITs).

2. Getting prepared — drafting irrevocable trusts now so that clients can quickly gift to those trusts if a legislative change appears imminent

- If legislation to reduce exemption amounts appears imminent, wealthy clients who have not fully utilized their gift tax exemptions may want to act quickly.
- Many estate planning attorneys (and appraisers) are extremely busy right now working with clients who are actively planning. Therefore, clients should consider engaging an estate planning attorney as soon as possible to draft trusts or other documents necessary for quick plan execution when desired. If clients want to gift assets that are difficult to value, they may also want to contact an appraiser now to discuss starting the valuation process.

Act now: For clients not already working with a lawyer, consider reaching out to your local bar association or estate planning council for recommendations. Additional resources to help find an experienced, accredited estate planning attorney in your client's area can be found **here.**

3. Locking in low interest rates with "wait-and-see" loans and sales to intentionally defective trusts

- For clients who may be unable or unwilling to make gifts today, consider leveraging the low interest rate environment to make loans as a "wait-and-see" strategy.
- A "wait-and-see" loan is a loan to an irrevocable trust (typically an intentionally defective trust). A similar strategy is for the grantor to sell assets to the grantor's intentionally defective irrevocable trust. Depending on what the client prefers to do, the trust can either repay the loan in full with adequate interest or the client can make a gift to the trust by forgiving all or a portion of the loan.

- The borrowed funds are often used to pay the premiums on a life insurance policy inside of the trust to potentially increase the net to heirs. Even if the client decides to be repaid under the loan terms, the insurance remains in the trust as a source of income- and estate-tax-free liquidity for beneficiaries.
- These strategies lock in low applicable federal rates of interest (April's long-term rate is 1.98%), put the insurance in place today and shift potential growth outside of the client's taxable estate, all without requiring the client to make a decision about gifting now.

Act now: Learn more about the "wait- and-see" loan technique here. John Hancock's private financing and sale of an asset to an intentionally defective trust modules can also be used to illustrate the potential benefits of these strategies.

4. Putting personally owned life insurance in place now, while planning for a potential future policy transfer

- Considering the Biden administration's tax proposals, high-income earners, particularly those earning more than $400K annually, may find the income tax benefits of life insurance more attractive than ever. For these individuals, personal ownership structured for either (1) maximum cash accumulation potential to generate income-tax-free supplemental income in the future or (2) for maximum death benefit may be desirable.
- If it appears that a reduction in the estate tax exemption is imminent, the insured/owner can consider either of the following:
  - Gifting the policy to an ILIT at a future date (note the gift of a policy on the donor's life is subject to estate tax inclusion for three years following the gift), or
  - Selling the policy to an ILIT for full and adequate consideration (which should avoid the three-year rule), providing the sale meets an exception to the transfer for value and reportable policy sale rules.

Act now: If a future transfer of the policy to a trust is likely, for survivorship policies, financial professionals can consider discussing John Hancock's estate preservation rider with clients (designed to provide additional death benefit for the first four policy years to offset some risk of estate tax inclusion), as well as the possibility of using a standby trust. **Learn more.**

5. Planning for generational wealth transfer

- The Biden administration could support legislation limiting the duration of irrevocable trusts.
- Clients can consider whether to create and fund an irrevocable trust now that is exempt from the generation-skipping transfer ("GST") tax, hoping the trust would be grandfathered from any subsequently enacted duration limitations on the trust.
- Drafting attorneys can consider permitting the trust to purchase life insurance on the life of any trust beneficiary in whom the trustee has an insurable interest. The trust must be structured to avoid giving the insured any powers or rights over the policy that would trigger estate tax inclusion in the insured's estate.

Act now: These types of trusts, such as dynasty trusts, are often funded with life insurance and may provide valuable creditor-protection benefits and substantial transfer-tax savings, as assets remain in trust for multiple generations.

6. Accelerating income and planning for income tax efficiency

- Clients who believe their income tax rates will increase in 2022 or later years (if the Biden tax proposals are enacted or because they anticipate more taxable income in future years), may consider accelerating income by evaluating:

– Accelerating bonuses into 2021 rather than waiting until 2022

– Converting traditional IRAs to Roth IRAs in 2021 or prior to the effective date of potential future income tax rate increases

– Triggering the recognition of capital gains prior to the effective date of potential future income tax rate increases on capital gains

- As income tax rates increase, the taxable equivalent yield on life insurance cash values and death benefits should become increasingly attractive. High-income earners may be interested in life insurance as a potential source of discretionary, tax-free supplemental retirement income.

Act now: Talk to your clients about the income tax benefits life insurance offers and how it can be used to help supplement other retirement accounts by providing a source of tax-free income to pay for unexpected costs, offset inflation and/or investment losses, or help pay for long-term care (when an LTC rider is added). **Learn more.**

7. Planning for a loss in step-up in basis

- The Biden administration could support legislation eliminating or reducing the basis step up at death.
- Clients with large amounts of built-in, long-term capital gains may trigger capital gains taxes currently if they believe capital gains tax rates will increase in the future and that the basis step up at death will be eliminated or reduced.

Act now: Talk to your clients about the potential loss of the step-up in basis. The income-tax-free death benefit from life insurance can be used to help offset the income tax liability due if the basis step up is eliminated or reduced. Additionally, buy-sell agreements will need to be revisited as the selling party at death may have an additional income tax consequence to plan for if the basis step up is eliminated or reduced. The selling party's heirs may need additional life insurance death benefit on the seller's life to offset this income tax.

8. Charitable planning in 2021

- Under a special provision in the CARES Act, cash gifts made in 2020 and 2021 directly to qualified public charities (donor-advised funds do not qualify for this exception) may generally be deducted up to 100% of adjusted gross income (AGI).

– Charitably inclined clients may be able to make such charitable gifts in 2021 to offset other income recognized in 2021 (see item #6 above)

– In a low interest rate environment, charitable lead trusts are also relatively more attractive from a wealth-transfer planning perspective

Act now: The income tax savings from tax-deductible **charitable gifts** may also be used to purchase life insurance to address wealth-transfer planning objectives and other liquidity needs.

Financial professionals have an outstanding opportunity to discuss these planning opportunities with their clients now.

For more information, please call *Advanced Markets*
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Trusts should be drafted by an attorney familiar with such matters in order to take into account income and estate tax laws (including the generation-skipping tax). Failure to do so could result in adverse tax treatment of trust proceeds.

Life insurance death benefit proceeds are generally excludable from the beneficiary's gross income for income tax purposes. There are few exceptions such as when a life insurance policy has been transferred for valuable consideration.

The IRR on death benefit is equivalent to an interest rate at which an amount equal to the illustrated premiums could have been invested outside the policy to arrive at the net death benefit of the policy.

Loans and withdrawals will reduce the death benefit, cash surrender value, and may cause the policy to lapse. Lapse or surrender of a policy with a loan may cause the recognition of taxable income. Policies classified as modified endowment contracts may be subject to tax when a loan or withdrawal is made. A federal tax penalty of 10% may also apply if the loan or withdrawal is taken prior to age 59 1/2.

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