Last week House Democrats proposed changes to the federal tax code that, if enacted, would dramatically shift the estate tax landscape, including the elimination of many common estate tax mitigation strategies. Although there are other tax-related changes in the proposal, this alert focuses on those most pertinent to estate planning. Of course, the legislative process is very much in flux and it is possible that these proposals may not be enacted in their current form. Still, there may well be limited time to act, and the potential consequences are significant enough to consider taking immediate steps.

Use Your Federal Gift and Estate Tax Exemption Now

The federal gift and estate tax exemption is the total amount that you can transfer to individuals, either during your life or at death, before generating federal gift or estate tax. The current exemption is $11.7 million per person ($23.4 million for married couples) and is adjusted upwards each year for inflation. Under current law it is set to be cut in half in 2026. However, under the new tax proposal, this reduction would take place on January 1, 2022.

For those with enough wealth to consider gifts of this magnitude, the stakes are high. The combined Federal and Massachusetts estate tax rate is approximately 50%. For those in a position to give away the $11.7mm or $23.4mm currently, the tax savings versus leaving the same amount at death (by which time the exemption will presumably have been reduced) will be millions of dollars.

A Popular Strategy is Targeted

Accelerating the 50% reduction of the tax exemption has been a possibility we have addressed in past publications and you can read about different strategies we have suggested here. But the tax proposal also contains a new feature that targets so-called "grantor trusts," which include the "Spousal Lifetime Access Trust" (SLAT).

As the gift and estate tax exemption has risen, SLATs have become popular vehicles to receive lifetime gifts. With a SLAT, one spouse (the "donor" spouse) uses the $11.7mm exemption to fund an irrevocable trust for the benefit of not only descendants but also the other spouse (the "beneficiary" spouse). Because distributions from the trust may be made to the beneficiary spouse, structuring the trust this way provides an escape hatch of sorts (admittedly an imperfect one, as the death of the beneficiary spouse—or divorce—can close the hatch). Still, the inclusion of the beneficiary spouse is often a key factor in achieving the requisite comfort to make a large (and irrevocable) gift.

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SLATs are a subset of grantor trusts, a term used to describe trusts that are distinct entities from the donor for estate and gift tax purposes, but are taxed to the donor for income tax purposes. This means that grantor trusts are excluded from the donor's estate, but the income earned by the trusts flows to the donor's return. Grantor trusts are excellent wealth transfer tools, as the ability for the donor to pay the trust's taxes enriches the trust tremendously, allowing the trust assets – that pass outside the donor's estate – to grow unencumbered by income taxes. The proposal would call for all grantor trusts to be included in the donor's estate, effectively ending them as an estate planning tool going forward. Furthermore, this change would be effective upon enactment of the legislation, which could be as soon as late September or early October.

The changes to the rules relating to grantor trusts, including SLATs, would apply to new grantor trusts created after the date of enactment of the proposed legislation. Pre-existing grantor trusts would generally be grandfathered, with a huge caveat—they are only grandfathered to the extent of the amounts funded prior to the legislation, and it is possible that certain transactions between the donor and the trust on or after the date of enactment would also be snared by the new proposal. Thus anyone who already has a grantor trust but has not yet fully funded it should seriously consider finish funding before the proposal is enacted. And for wealthy clients that have already fully funded grantor trusts, there may also be beneficial transactions to consider, such as paying down debt between the donor and the grantor trust, or swapping out assets for income tax basis planning.

Related Strategies Also at Risk

While we have focused primarily on SLATs here because they have become a common estate planning vehicle, the tax proposal would effectively eliminate all new grantor trusts, which is a broad category of trusts that also includes grantor retained annuity trusts (GRATs), qualified personal resident trusts (QPRTs), and other similar vehicles.

Action Items

1. If you are interested in establishing a SLAT or other form of grantor trust, now is the time to act. Keep in mind that this process generally takes a minimum of a few weeks and must be completed before the proposal is enacted. In addition to making a number of important decisions about the structure of the trust, you must also address all the logistical components of opening the new trust account with a financial institution, identify the assets to transfer, and, in many cases, reshuffle account titling prior to the funding.

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2. If you already have a SLAT or other type of grantor trust but have remaining gift and estate tax exemption and the means to make additional gifts, it may be worth funding it further.

3. Although the elimination of SLATs and other forms of grantor trusts may be the first chip to fall, there is also not a lot of time to act on the 50% reduction in the tax exemption, which would apply to all forms of gifts effective January 1, 2022. As such, you might also consider outright gifts or transfers to non-grantor trusts.

It is impossible to know when or whether this legislation will pass, and what any final bill will look like. But for those individuals in a position to take advantage of the current favorable tax climate, there is no time like the present.

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