Title: Four More Years: Time for Interest Rates, Inflation, and Basis to Re-Take Center Stage?

Authors: Andrea Kushner, JD and Thomas Pauloski, JD

On the Chinese calendar, 2021 was The Year of the Ox, but for many in the estate planning world, it was The Year of the Exclusion. Due to concerns that Congress might slash the gift and estate tax exclusion[1]—perhaps retroactively—from $11.7 million to something much, much lower, estate planners encouraged their wealthiest clients to make large gifts in 2021, and many followed that advice. As the year evolved, Congress withdrew proposals to reduce the exclusion, and some clients who were on the fence held off on making big gifts in 2021. Today, it appears that the exclusion amount—now a lofty, inflation-indexed $12.06 million—may be safe until 2026, when it is scheduled to be halved.

For clients who waited and can afford to make a big gift—and especially for those who live in a jurisdiction that imposes an estate tax at death, but not a gift tax on transfers during life[2]—current use of the exclusion may be the optimal strategy. But with the heightened exclusion amount seemingly safe for the next four years, and with interest rates and inflation running hot, should clients and their advisors, perhaps, think differently about the exclusion in 2022 than they did in 2021?

Will Congress Build Back Better?

Soon, Congressional Democrats will revive efforts to enact the party's ambitious social agenda, styled the "Build Back Better Act," which stalled last December primarily due to objections raised by centrist Senator Joe Manchin (D-WV). Senator Manchin has indicated willingness to support a bill that is narrower in scope (i.e., fewer initiatives), the costs of which are fully offset by tax increases and other revenue raisers, and the party seems to be rallying—somewhat reluctantly—around this structure. Most commentators believe that a slimmed-down bill will be limited to child-care, healthcare, and climate initiatives, and will exclude paid-leave, free community college, Medicare expansion, and certain other ideas that Democrats floated in 2021.

Senator Bernie Sanders (I-VT) has suggested a separate vote on each initiative, which would force Senators to specify the spending programs they support and those they oppose, but Representative Nancy Pelosi (D-CA), the House Majority Leader, recently indicated that all proposals would be part of a single bill. Senator Chuck Schumer (D-NY), the Senate Majority Leader, has expressed an intent to pass the legislative package late in the second quarter of 2022, which probably means June.[3]

Under current protocols, a bill generally requires 60 votes to pass in the Senate. Because the Democratic caucus controls, at most, 50 votes, any bill that lacks the support of at least 10 Senate Republicans may need to be passed using an alternative procedure called "reconciliation." When

---

[1] In the language of estate planning, the "basic exclusion amount." *See* Section 2010(c)(3) of the Internal Revenue Code of 1986, as amended.

[2] Twelve states and the District of Columbia currently impose estate taxes at death; of those, only Connecticut also imposes a gift tax on lifetime transfers. A handful of states impose inheritances tax on certain beneficiaries of wealth received upon the death of a benefactor. *See* Emily Brandon, "17 States with Estate and Inheritance Taxes," U.S. News (Aug. 30, 2021) https://money.usnews.com/money/retirement/aging/articles/states-with-estate-and-inhertance-taxes.

[3] See Andrew Duehren, "Democrats Start to Sketch Out Revived Build Back Better Package," Wall St. J., U.S. News (Jan. 22, 2022) https://www.wsj.com/articles/democrats-start-to-sketch-out-revived-build-back-better-package-11642771824.

reconciliation applies, the votes of just 50 Senators, with the concurrence of Vice President Kamala Harris, are necessary. But reconciliation is limited to matters relating to taxes, spending, and the debt limit.[4] A key procedural component is that, absent extraordinary circumstances, there can be just one "omnibus" reconciliation bill each fiscal year, which ends September 30. It's unclear how Senator Sanders proposes to introduce and pass multiple reconciliation bills before October 1 without any Republican cooperation.[5]

Whether these initiatives advance as a single bill or multiple bills may be extremely important. If there is a single, omnibus reconciliation bill that has the same price tag (approximately $1.75 trillion) as the bill that was abandoned back in December, then the revenue raisers in that abandoned bill presumably would be brought forward into the new bill, with no apparent need to introduce additional income or transfer tax increases. On the other hand, if each initiative advances as a separate bill, as proposed by Senator Sanders, then the cost of each such bill would need to be offset, presumably by some of the revenue raisers from the abandoned bill. But what if there isn't a perfect economic match of cost versus revenue for each separate bill? Could some other tax proposals that fell by the wayside in 2021—a reduction to the estate and gift tax exclusion, changes to laws governing so-called "grantor" trusts, restrictions on valuation discounts for transfer tax purposes, and the like—be revived in 2022? This possibility seems more likely if there are individual bills, rather than a single, omnibus bill. If there is going to be "Build Back Better 2.0," those who favor gift and estate tax laws as they are today should be rooting for a single bill, it would seem.

Is the Exclusion Now Tamper-Resistant?

The gift and estate tax exclusion currently stands at an inflation-adjusted $12.06 million per person, $24.12 million per couple. Under current law, the exclusion will continue to grow with inflation until 2026, when "sunset" of the Tax Cuts and Jobs Act of 2017 will cause it to be halved, absent action by a future Congress. Unless the Republicans were to "sweep" the White House, Senate, and House of Representatives in the 2024 election, such future action seems unlikely. As shown in Display 1, we expect the exclusion amount to increase to about $13.1 million by 2025, then drop to about $6.8 million in 2026.[6] In other words, without further action, the exclusion should remain elevated for the next four years.

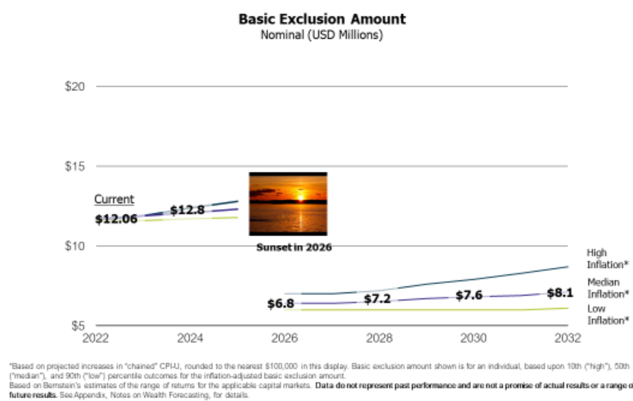
---

[4] See David Wessel, "What Is Reconciliation in Congress?," Brookings, (Feb. 5, 2021) https://www.brookings.edu/blog/up-front/2021/02/05/what-is-reconciliation-in-congress/.

[5] On May 28, 2021, Senate Parliamentarian Elizabeth McDonough opined that only one reconciliation bill may proceed to the floor of the Senate each fiscal year, absent the approval by the Senate Budget Committee. That Committee currently consists of 11 Democrats and 11 Republicans. Ordinarily, an 11-11 split would be enough to get a bill to the Senate floor. But the Republicans could block that result by unanimously boycotting any vote on the bill. Such a boycott would deny a quorum in the Budget Committee and stall the bill indefinitely. Thus, it would appear, multiple reconciliation bills would require the cooperation of at least one Budget Committee Republican—and that cooperation does not appear to be in the offing. See Paul M. Krawzak, "Parliamentarian Guidance Deals Blow to Reconciliation Strategy," Roll Call (Jun. 2, 2021) https://rollcall.com/2021/06/02/democrats-reconciliation-strategy-dealt-blow-senate-parliamentarian/.

[6] These figures assume three-percent inflation in each of the next three years.

Display 1: One Way or Another, the Basic Exclusion Amount Is Likely to Be Reduced



A year ago, the estate planning community was very concerned about President Biden's proposal to slash the exclusion amount in half; Senator Sanders proposed to reduce the exclusion even further—to $3.5 million, with only $1 million of that amount available during life. In addition, there appeared to be a very real threat that any such cut might be effective retroactively, perhaps to January 1, 2021. All last year, but particularly during the early part of 2021, many attorneys prepared wealth transfer plans that would use a client's full exclusion, but in a way that would not result in the imposition of gift tax in the event of a retroactive reduction to the exclusion amount.[7]

Today, are we right back where we were at the beginning of 2021? Could Congress enact legislation that retroactively reduces the gift and estate tax exclusion for gifts made this year? It's possible, but such a retroactive reduction seems unlikely, for several reasons. First, the Democrats seem focused on downsizing the Build Back Better Act, not on adding provisions that could complicate already delicate negotiations. Second, the current focus appears to be on tax provisions that raise substantial revenue; a decrease to the exclusion does not seem to fall within that category. Third, a reduction to the exclusion would not be popular with many influential contributors to political campaigns; Senate and House Democrats facing tightly contested races in the fall elections need as many friends—and as many dollars—as they can get! Nevertheless, there was no great hue and cry from the centrists in 2021 when President Biden and Senator Sanders, among others, proposed a reduction to the exclusion amount—unlike the proposals to eliminate the step-up in income tax basis at death or to increase individual income tax brackets, which met centrist resistance. Most Democrats don't seem opposed to reducing the exclusion; they just may not consider it a high priority in the current climate. In sum, a retroactive reduction to the exclusion is possible, but seems much less likely in 2022 than it did early in 2021.

---

[7] Several strategies may be used to avoid or mitigate gift tax in the event of a retroactive reduction to the gift and estate tax exclusion, including (1) gifts to trusts that could (if necessary) qualify for gift tax marital deduction, (2) gifts to trusts that could be disclaimed, (3) gifts that would be limited to an amount specified in a so-called "defined value clause," and (4) loans that could be forgiven if adverse legislation did not materialize. *See* Bob Dietz & Tom Pauloski, "Could a Change to the Estate and Gift Tax Exclusion Be Retroactive?" Wealth Management (Feb. 17, 2021) https://www.wealthmanagement.com/estate-planning/could-change-gift-and-estate-tax-exclusion-be-retroactive.

If Current Use of the Exclusion Is No Longer a Priority, What Is?

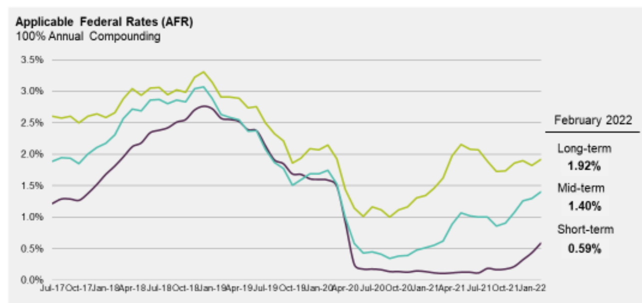
If the Democrats don't reduce the gift and estate tax exclusion this year, they may not get the chance to do so in 2023 or 2024. Most analysts believe that the Republicans will regain control of the House of Representatives in the 2022 election, notwithstanding court-mandated adjustments to gerrymandered Congressional districts in several states, including Ohio. If those analysts are correct, then it seems very unlikely that a GOP-dominated House would vote to reduce the exclusion before 2026. And even if the Democrats were to regain control of Congress in the 2024 election, how likely is it that they would expend political capital to reduce the exclusion retroactively in 2025 … when that reduction is already on track, without further action, for 2026? No, if the Democrats want to reduce the exclusion before 2026, they need to do that now, but it doesn't seem to be a priority.

Should estate planners concentrate their attention elsewhere? In many cases, we advise our clients to think beyond the exclusion to consider other possibilities. Three specific issues merit particular attention:

- *Rising interest rates*.

  Without question, the high exclusion amount and low interest rates are key drivers of estate planning today. But the threat of a near-term reduction to the exclusion appears to be minimal, while interest rates are starting to move in a direction that is detrimental to our clients, as shown in Display 2:

Display 2: Potential Strategy: Lock in Today's Still-Low Interest Rates…But Retain the Option to Complete the Gift Later



Source: www.irs.gov

When advice depends primarily on two key variables, one of which (the inflation-adjusted exclusion) is moving in our clients' favor and the other (interest rates) to their detriment, which should you "lock in" first? Today, all other things being equal, consider locking down currently low interest rates. For example, a client could sell, rather than give, assets to an irrevocable ("intentionally defective") grantor trust (IGT), and take back a promissory note that bears annual interest at a rate of as little as 0.59%, the short-term applicable federal rate (AFR) for February 2022. The client could forgive that debt and complete the gift at any time, if political developments make that step necessary. In the meantime, the client can simply keep the debt in place, assuming that the growth rate

of the assets sold to the IGT has a high probability of exceeding the interest rate on the note.

- *Rising inflation*.

  Until recently, inflation had not been a serious threat in the United States for nearly four decades. But the recent uptick in inflation threatens investors—and has a trickle-down effect on estate planning strategies. Here's how:

  - Inflation increases the value of capital—at Bernstein, we call that amount "core capital"—that clients need to maintain on their personal balance sheets to meet their lifetime spending goals with a high level of confidence. Lower return expectations for both stocks and bonds exacerbate this problem.

  - As a result, many clients may be unable to afford a current gift of $12.06 million for the benefit of, say, children and younger descendants.

  How can this risk of portfolio depletion be hedged?

  - One option is to give away only future *growth* of investments, rather than the underlying investments themselves. Fortunately, the very same installment sale strategy that can lock-in current interest rates also provides a hedge, of sorts, against future inflation. In other words, a sale has the potential to hedge both legislative risk (i.e., the risk that the exclusion amount may be reduced sooner than we expect) *and* inflation risk (i.e., the risk that a client may be unable safely to afford a big gift).

  - For married clients, a spousal lifetime access trust (SLAT) may be a viable hedge against future inflation. In a SLAT, the grantor's spouse is a permissible—perhaps the primary—current beneficiary of the trust. If necessary, the trustee of the SLAT could distribute assets to the beneficiary spouse, thereby bringing assets back onto the marital balance sheet, and thus giving the grantor an indirect "string" on the trust assets.[8] Note that a SLAT is not a panacea: Divorce, or death of the beneficiary spouse, effectively would cut off the grantor's indirect access. As a further hedge, assets could be sold, rather than given, to the SLAT, thereby providing two means of continuing access to trust assets: Repayment of the grantor's note and trust distributions to the beneficiary spouse.

  - Finally, the client could give the exclusion amount directly to the intended beneficiaries, or to a *non*grantor trust for their benefit. The client would need to retain enough core capital to meet her or his lifetime spending needs, but would *not* need to maintain a separate reserve to satisfy annual grantor trust income tax obligations.

---

[8] Given the potential estate tax and creditor protection benefits, a SLAT arguably should be thought of as the distribution source of last resort.

- *Basis and income tax planning*.

  The current exclusion amount will shelter more than $24 million per couple from gift and estate tax. At that level, very few families—only about 1-in-1,500 or so[9]—will have an estate tax problem in the event of a death prior to 2026. For those whose estates fall below the exclusion amount, *income* tax planning should take priority over estate tax planning, in most cases.

  Income tax planning may take priority even for the 1-in-1,500 families who have looming estate tax issues. Consider, for example, an older client who owns highly appreciated assets. Transferring those assets prior to death would eliminate any estate tax on future growth of those assets, but also could result in the loss of a step-up in the income tax basis of those assets upon the transferor's death. The key question for such a client is this: How long will it take the transferred assets to appreciate enough so that the benefit of avoiding estate tax on the future growth will exceed the detriment of losing the step-up, not just on the future growth, but also on the "built-in" appreciation of the assets at the time of transfer? The lower the basis, the longer it will take for the expected estate tax savings to exceed the income tax damage done due to loss of the step-up. The expected halving of the exclusion amount in 2026 adds a complex mortality component to this analysis.

  Although feared increases to income tax rates did not materialize in 2021, our clients remain interested in strategies that can defer or eliminate income taxes. Two such strategies stand out as we look ahead to 2022:

  - Charitable remainder unitrust (CRUT). For holders of very-low-basis investments, potentially including interests in a closely held business, a CRUT may provide an attractive way to defer the recognition of capital gain income that a client otherwise would recognize upon sale. To implement this strategy, the client would contribute appreciated assets to the CRUT in advance of sale. At that time, the trustee would invest the cash proceeds and "book" the capital gain; as a charitable entity, a charitable remainder trust pays no income tax. After the sale and during the client's lifetime, the CRUT would pay her a specified percentage of the trust assets, revalued each year. Each such payment would "carry out" a portion of the previously deferred capital gain tax liability to the owner on a Schedule K-1. In many cases, the economic benefit of deferring the capital gain tax hit over one's lifetime will greatly exceed the incidental benefit payable to charity upon the owner's death. But as with many estate planning strategies, there are potential downsides. With any charitable remainder trust, a portion of the sale proceeds would be effectively locked-up for the client's lifetime. Further, the strategy, if funded with S corporation stock, will negate the corporation's subchapter S election. For businesses that are taxed as partnerships, there are a host of issues prior to sale, including the potential for unrelated business taxable income (UBTI). And there is mortality risk: If the client dies shortly after the creation of the charitable remainder trust, charity would

[9] *See* Tax Policy Center, "Key Elements of the U.S. Tax System" (May 2000) https://taxpolicycenter.org/briefing-book/how-many-people-pay-estate-tax (approximately 1-in-1,474 families in 2020); Richard Phillips and Steve Wamhoff, "Why the Estate Tax Is Important," Inst. on Tax'n and Econ. Policy (Dec. 6, 2018) https://itep.org/the-federal-estate-tax-an-important-progressive-revenue-source (approximately 1-in-1,538 families in 2018).

disproportionately benefit from the strategy. Finally, deferring income taxation into the future may cause the owner to pay tax at higher marginal federal and state rates; the same may be said for deferred compensation arrangements and qualified plans. A client with a very long investment horizon stands to benefit most from deferral using a CRUT. All of these benefits and risks must be identified and assessed by the client's tax and investment advisory teams before implementing a CRUT.

- Private placement life insurance (PPLI). Properly structured life insurance potentially offers unique income tax benefits, including tax-free growth during the insured's lifetime and a full step-up in basis at death, even if the insured does not then own that policy. Given these benefits, qualified purchasers and accredited investors should consider investing in certain high-returning, tax-inefficient alternatives through low-cost PPLI, rather than directly. The potential for future tax rate increases (e.g., proposed five- and three-percent surcharges that were part of the House version of the Build Back Better Act) make investing through PPLI even more appealing.

Estate planning today is as complicated as ever. Leverage your Bernstein advisor and the resources of our firm to help you quantify the wealth transfer opportunity. We will continue to monitor the progress of any tax legislation and keep you informed. As always, we are eager to work with your tax professionals to provide analysis and develop a plan that fits your individual circumstances.

The views expressed herein do not constitute and should not be considered to be, legal or tax advice. The tax rules are complicated, and their impact on a particular individual may differ depending on the individual's specific circumstances. Please consult with your legal or tax advisor regarding your specific situation.