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PRIVATE WEALTH MANAGEMENT | ARVEST

WHAT IS THE 99.5% ACT?

Important Information Investors and Their Advisors Should Know

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The 99.5% Act is a comprehensive piece of estate and wealth transfer tax legislation which would substantially decrease the amount of assets a client could transfer to their heirs by decreasing exemptions and increasing tax rates. In addition, it would also close many so-called estate planning loopholes that people have used for many years. These planning strategies could no longer be used to save the imposition of substantial transfer taxes. It would effectively change the estate planning marketplace into one which many planners and their clients will no longer recognize.

What does the 99.5% Act propose?

The 99.5% Act is extremely significant and complex, but quite simple in how it would achieve its goals:

- Reduce the current estate and generation skipping tax exemptions to $3.5 M, and the gift tax exemption to $1 M.
- Current flat estate tax rate of 40% will also go up if the proposed bill is passed.
- Transfer tax will become progressive, with the new rate starting at 45% for taxable estates between $3.5 and $10 M, 50% for estates between $10 M and $50 M, 55% for estates between $50 M and $1 B, and 65% for estates over $1 B.

ABOUT THE AUTHOR

Mr. Boekeloo is a tax attorney who has provided tax and legal consulting services to independent financial advisors, CPAs, financial institutions and attorneys for over 20 years. His expertise is in estate and income tax planning for high net worth and ultra-high net worth individuals, business succession planning for closely-held businesses, and executive benefit solutions for key employees of companies.

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Remember those so-called tax loopholes that were mentioned? Clients will no longer be able to have assets sold to defective grantor trusts that are disregarded for income tax purposes, which would make those assets unable to be removed from their estate, receive (in most situations) substantial discounts for the gifting of family limited partnership interests, use grantor retained annuity trusts to freeze the value of an estate, nor create dynasty trusts and get substantial generation skipping tax benefits. The use of annual exclusion gifting would also be curtailed.

What should clients do to prepare for these changes?

The 99.5% Act would have a profound effect on millions of American families who have spent years building their wealth and intended on utilizing well-established tax and estate planning strategies to maximize the amount of wealth transferred and minimize the associated tax impact. Many do not expect such prompt action after the coronavirus pandemic of the last year. Families will need to act quickly to preserve their wealth in what could be the most significant estate tax changes in decades. A call to their advisor can help clients understand these changes and their impacts and start the process of planning to help them minimize risks. Since many of the above- mentioned planning strategies will be eliminated when the Act is passed and signed by the President, prompt planning is essential. It is likely that the passage may occur sometime in the fall. The enactment of planning can take a considerable length of time if appraisals are necessary or if significant and complex documents need to be created. In addition, the use of the $11.7 M exemption may only be effective till the end of the year; although this timeframe may be a little greater, it still is quite short. The closer we get to the end of the year, the busier the attorneys and appraisers will become. If clients wait too long, they may find that they are unable to get the necessary planning done.

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Who is supporting this bill?

On March 25th, the 99.5% Act (the most significant transfer tax legislation in 20 years) was introduced in the Senate by Senator Bernie Sanders and co-sponsored by Senators Gillibrand, Whitehouse, Reed, and Van Hollen. A similar version will be introduced in the House of Representatives by Representative Jimmy Gomez. The legislation appears to have broad support by the Democratic majorities in both the House and Senate. In the Senate, it would probably be enacted pursuant to the Budget Reconciliation Rule, which would require all 50 Democrats to vote for the bill and Vice President Harris to provide the tie-breaking vote. Reconciliation is only allowed once per fiscal year, so the bill probably would not be passed until after October 1, which is the start of the new fiscal year.

When would the changes take place?

It would reduce the current estate and generation skipping tax exemptions to $3.5 M, and the gift tax exemption to $1 M starting on January 1, 2022. The current flat estate tax rate of 40% will also go up starting on January 1, 2022 if the proposed bill is passed. The more difficult news for many clients is that many of the primary tools and strategies that have been used in the past will no longer be available for use if the legislation is enacted. However, generally all these arrangements entered into prior to the enactment of the bill would be grandfathered in (except where mentioned below) if they had not been added to or altered after the bill had been passed.

What are some of the most significant tax/exemption changes?

The most significant changes are threefold. First, the reducing of the exemption from 11.7 M to 3.5 million. Second, the increase of the transfers rates for estate, gift, and generation-skipping transfer taxes. Third, not having the exemptions be indexed for inflation as they are currently. Many may attempt to make gifts up to the full amount of the current exclusion before it is eliminated. The excess of the $11.7 M over $3.5 M not used by December 31, 2021, would be lost. By using the full exclusion, a single person could remove an additional $8 M from their estate, saving them around $4 M in estate taxes plus any growth of those assets during their lifetime. A married couple could save twice that amount. The downside of using the full exclusion is the investors do not want to give up access or control, but they also do not want their heirs to pay increased taxes.

An example is necessary to show someone could meet these divergent goals. Joe and Linda are worth $15 M. Joe creates a Spousal Lifetime Access Trust (SLAT) for the benefit of Linda and their children. Linda would be a discretionary beneficiary, making it impossible to qualify for the unlimited marital deduction. Since Joe is married to Linda, he would have indirect access to the trust assets through distributions made to her. A life insurance policy on Linda's life owned by an irrevocable life insurance trust, where Joe is a discretionary beneficiary should be considered, in the unlikely event that Linda dies first. The full value of the SLAT would not be included in either Joe's or Linda's estate. The remainder of their estate would be covered by Linda's $3.5 M exemption. This would substantially reduce their potential combined estate tax liability but must be created and funded by the end of this year.

How will this impact existing planning techniques?

A significant change under the Act is the elimination of valuation discounts (except for active business arrangements). Under current law, Arnie and Martha (a married couple) could place $15 M of assets into an LLC, and then each spouse could sell a 49% ownership in that LLC for a $5 M note each, to an irrevocable trust, assuming a 33% discount. This type of valuation arrangement would not be allowed under the new Act. This Act would amend the Internal Revenue Code and require that family entities base their valuation on a pro rata percentage of the ownership times the value of the underlying assets in the entity. In the above example, the sale of the LLC interest would then become $7.5 M each, causing a significant increase in estate tax on the death of the latter of Arnie or Martha. The exceptions to this rule in the Act are minimal. If investors wish to engage in this discount strategy, they must complete it and fund it prior to the enactment of the bill.

One of the most crushing blows to the estate planning community under this Act would be the addition of Section 2901, which would mandate that any trust created, funded, or transacted after the enactment of the law would be considered owned by the grantor for income tax purposes (typically called a grantor trust) and would be subject to federal estate tax as if the grantor had owned the assets outright. Currently, a taxpayer can create a trust that will not be subject to federal estate tax but would be considered owned by that taxpayer for income tax purposes. This allows the grantor to pay the income tax on trust earnings without the payment being considered a gift. This also creates a substantial amount to pass to trust beneficiaries transfer tax-free. In addition, the taxpayer can sell significant assets to the trust for long-term, low interest rate promissory notes, which may vanish at the taxpayer's death without triggering any income tax on the exchange. Any assets in any one of these trusts would be outside of the estate if they are not modified after the date of enactment. This can be extremely troubling if one of the assets in the trust is a life insurance policy.

An example is necessary to illustrate this significant loss of including the grantor trust in the grantor's estate. Five years ago, Erik and Lara were worth $30 M, $25 M of which was an S Corporation owned entirely by Erik. Erik recapitalized the corporation into 49% non-voting and 51% voting stock. He then sold the non-voting stock to a grantor trust for nine years interest-only note, followed by a balloon. The appraiser determined that the non-voting stock was worth $7.5 M. Since the midterm interest rate at the time was 2%, the trust only had to pay Erik $150,000 of interest per year. The pro rata portion of Erik's S Corporation income distributed annually to the trust is $1.5 M. The $1.35 M left over after the interest payment was split equally between the building of a side fund and making premium payments on a survivorship policy on Erik and Lara lives. Although we are not completely sure how the grandfathering rules would work, prudence would require the gifting of a significant amount to the grantor trust to allow for repayment of the note in full. The fear is that any activity between the grantor trust and Erik after the bill's enactment would cause full estate inclusion of all the assets of the grantor trust, including the value of the life insurance policy which would be the death benefit if Lara predeceases Erik.

The Act would effectively eliminate the efficacy of the use of the Grantor Retained Annuity Trust (GRAT). Using a GRAT, a client can place highly appreciating assets into a trust and have all the growth on the assets above the GRAT's low rate of return outside of the grantor's estate. The reason short-term GRATS are desirable is because of the mortality risk of the GRAT. If the grantor/annuitant dies prior to the termination of the GRAT, it would be all included in their estate and the GRAT would fail.

For example, a taxpayer could put $20 M of stock in a trust that pays $10 M back to the grantor for two years (plus a small interest payment), with the imposition of little or no gift tax. Anything that remains in the GRAT after these two annual distributions would pass to the beneficiaries' estate and gift tax-free. Often, when the grantor receives these payments, he will put them into new GRATS for an identical two-year period. This rolling GRAT strategy has been immensely powerful in a volatile marketplace. The Act would eliminate the short-term GRAT and require GRATS to have a minimum of ten years, with a taxable gift of either 25% of the market value of the assets placed in the trust, or $500,000. Because of this increased mortality risk and the potential gift tax liability, this provision would eliminate the use of GRATS. Clients who have assets which can highly appreciate should consider creating GRATS immediately before the bill is enacted. In the low interest rate environment, we are currently in, GRATS remain a powerful transfer strategy until the law changes.

The Act would substantially restrict the use of so-called dynasty trusts, and for those who have established one, planning needs to be done to avoid an unanticipated generation-skipping transfer tax. Under current law, a long-term trust can be created where multiple generations can receive distributions under the ascertainable standard of Health, Education and Maintenance Support (HEMS) or subject to a purely discretionary standard. These distributions would not be subject to an estate tax nor a generation skipping tax if the GST allocation were made to the trust. The new legislation would cap a trust that would otherwise be exempt from the generation skipping tax to a 50-year term and would cause taxable distributions or taxable terminations to be subject to the generation skipping tax. There is generally not any grandfathering to any prior GST trust regarding this 50-year rule. An example is necessary to illustrate this result. Joe funds a generation skipping trust with $11.7 M for the benefit of his 60-year-old child and his 35 and 40-year-old grandchildren. He allocates the full $11.7 M GST exemption to his trust. At the end of 50 years, the GST exemption will expire, and since Joe's son has deceased, a taxable termination will occur. The trust will then pay a generation skipping tax prior to making a distribution to the two beneficiaries. If the trust assets are between $10 M and $50 M, then the tax rate applicable will be 50%. The only positive thing about the Act dealing with dynasty trusts is that it did not change the non-GST for distributions for health and education. A trustee should consider making such health and education distributions to reduce the size of the trust (possibly to zero) to a minimal amount to avoid potential GST.

The provision of this Act that would probably affect the greatest number of people would be the curtailing of annual exclusion gifting. Under current law, a person can make up to a $15,000 gift to as many beneficiaries as he chooses and not be subject to a gift tax if they are gifts of present interest. The only limitation is the number of beneficiaries a person may have. For example, Grandfather Joe has ten grandchildren to whom he would like to make annual gifts. He can make $150,000 of gifts per year without having to use any of his applicable exclusions if they are not future interest gifts. As most sophisticated planners are aware, the annual exclusion can be leveraged by giving trust beneficiaries withdrawal rights (Crummey Powers) from a trust for a limited amount of time. The IRS has hated Crummey Powers since the day they were created by the Crummey Case.

The Act restricts annual exclusion gifting to $30,000 per donor, irrespective of the number of donees in the following four situations: (1) a transfer into a trust; (2) a transfer of an interest in certain family entities; (3) a transfer of an interest in an asset that is subject to a prohibition on sale; and (4) a transfer of an asset that cannot be immediately liquidated by the donee. An example is necessary to illustrate how these new rules make it more difficult to transfer wealth while still maintaining some degree of control over the next generation. Bill and Joan have four children. They can presently gift $120,000 into a trust and have it covered by the annual exclusion. This is based on the current $15,000 annual exclusion per donee rule. After the law passes, they will only be able to transfer a total of $60,000 into their trust for their children while the remaining $60,000 would have to be transferred outright or perhaps into a 529 plan.

ADVANCED PLANNING TEAM

apt *adjective*, definition:

1 : unusually fitted or qualified
2 : suited to a purpose:
3 : keenly intelligent and responsive

The Arvest Private Wealth Management Advanced Planning Team is a group of highly trained professionals who are organized to strategically address financial planning issues and create strategies in the advanced areas of wealth management for clients with complex financial planning needs. The team focuses on helping clients build, manage, protect and transition wealth with coordinated solutions designed to navigate the many dimensions of wealth planning.

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