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**Wealth Transfer Under the Biden Tax Plan**  
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President Joe Biden is proposing to eliminate “stepped-up basis” on property transferred at death. Under his plan, unrealized appreciation would be subject to capital gains tax at the time an asset is transferred by gift or bequest. This change, which reverses a century of tax law, would have far-reaching ramifications for investors.

This white paper considers the implications of a repeal of stepped-up basis, as well as other changes Congress might make to the gift and estate tax regime. The paper also sets out potential planning strategies for investors to consider to blunt the effects of the new rules.

*Biden’s Proposal*

Under current law, heirs take a basis in a decedent’s assets equal to the value of those assets on the date of the decedent’s death (a stepped-up basis). Thus, an heir never pays tax on unrealized appreciation that accrued during the decedent’s lifetime.

Biden’s proposal would require a deceased owner of an appreciated asset to recognize capital gain and pay tax on unrealized appreciation that accrued during the decedent’s lifetime. The gain would be recognized at the time of death. Similarly, an owner of appreciated property transferred by gift would recognize capital gain and pay tax at the time of the gift. These changes would be effective for gain on property transferred by gift after December 31, 2021, and gain on property owned at death by decedents dying after December 31, 2021.

Following are some of the details of Biden’s proposal:

- An individual would have a \$1M lifetime exclusion (\$2M for couples) from recognition of gain on property transferred by gift or held at death. In addition, the \$250K per-person (\$500K per couple) annual exclusion for capital gain realized on the sale of a principal residence would continue to apply.
- Gain would not be recognized on a transfer of property to a spouse. The spouse would assume the decedent’s basis in the property and would recognize gain upon disposition or death.

- Transfers of appreciated property to a charity would not generate a taxable capital gain.
- Tax on the appreciation of family-owned and -operated businesses and farms would not be due until the interest in the business is sold or the business ceases to be family-owned and operated.
- Taxable gain would be recognized when property is transferred to a trust or distributed by a trust. An exception is provided for transfers to a *revocable* trust wholly owned by the donor. In the case of a revocable trust, gain is recognized when the trust distributes property to someone other than the grantor (including on the death of the grantor).

### *Dynasty Trusts*

The Biden proposal would curtail the tax benefits of “dynasty trusts”, a popular planning technique used to avoid estate tax through multiple generations.

A dynasty trust remains in place for many future generations, or even indefinitely. A donor transfers to the trust property with a value not exceeding the lifetime exclusion (currently \$11.7M), incurring no gift tax. Because the trust never terminates, estate tax (and generation-skipping tax) is never due.

In many states, a “Rule against Perpetuities” limits the number of future generations that a trust may remain in existence. But some states have repealed the Rule against Perpetuities. In those states, dynasty trusts potentially may avoid paying tax through an infinite number of generations.

Biden’s proposal would require a trust (or other non-corporate entity) to recognize gain on a trust-held asset no later than ninety years from the date gain on that asset was last recognized. Under a transitional rule, the ninety-year period would begin on January 1, 1940, so the first possible recognition event would be December 31, 2030.

### *Planning Strategies*

If final legislation does include a repeal of stepped-up basis, investors could consider these potential planning strategies to blunt the adverse effects of the new rule.

- *Gift assets before they appreciate, thereby minimizing the capital gains tax on the transfer.* Under current law, it typically makes sense for an owner to hold rapidly appreciating assets until death, when stepped-up basis will avoid recognition of gain. If stepped-up basis is repealed, the opposite strategy would be more advantageous.
- *Transfer low basis assets to a spouse to defer recognition of gain, and transfer high basis assets to other beneficiaries, who will recognize gain.* Under current law, there often is little difference whether a decedent bequeaths low basis assets to a spouse or to other beneficiaries, as basis will be stepped up in either case. But if stepped-up basis is

repealed, it might make sense to transfer low basis assets to the spouse to defer recognition of gain until the spouse's later death.

- *Use the lifetime exclusion to avoid some capital gains tax.*
- *Consider purchasing life insurance.* Because life insurance death benefits are not subject to income tax, no capital gains tax is due. For more details on life insurance as an estate planning technique, see *Permanent Life Insurance as a Planning Strategy* below.

Most important, *investors should consider making gifts this year* before the new law would go into effect (presumably at year-end), and while the gift tax exemption is \$11.7M.

### *Complexities of Repeal Proposal*

Stepped-up basis has been a staple of the tax policy for many decades. The provision is necessary to avoid imposing both estate and income tax on inherited assets, thereby effectively taxing them twice.

Repealing stepped-up basis also presents challenges. Recognition of gain on gifted assets imposes a tax before the donor has the sales proceeds to pay. And determining a decedent's basis in assets acquired potentially generations ago can be difficult, especially for assets that are not readily traded, such as partnership interests, real estate, art, crypto currencies, and collectibles.

### *An Alternative: Changing the Estate Tax*

Congress will decide the terms of the final bill, albeit with deference to Biden's suggestions. Some Democrats in Congress already are raising concerns about the proposal to repeal stepped-up basis. The chairman of the House Agriculture Committee has proclaimed the plan "untenable." Other representatives have expressed similar reservations.

Other Democrats are beginning to put forth their ideas for tax policy changes. Senator Bernie Sanders has introduced a bill to reduce the estate tax exemption to \$3.5M and the gift tax exemption to \$1M. The Sanders bill calls for a progressive estate tax rate: 45% for estates up to \$10M, 50% for estates up to \$50M, 55% for estates up to \$1B, and 65% for estates over \$1B. (The bill retains stepped-up basis, except for transfers in trust.)

### *Prognosis*

Given the objections to, and complexities of, repealing stepped-up basis, we believe that a final tax bill may retain stepped-up basis in favor of broadening the application of the estate tax. Changing the parameters of the estate tax is far easier than establishing a new regime to track basis through generations. This approach is consistent with Biden's objective to increase taxes on the affluent.

If final legislation does alter the estate tax, we expect it will provide an exemption in the \$5.5M-\$6.5M range and a tax rate in the 40%-45% range, although it is far too early to predict with any certainty.

### *Planning Strategies*

If it appears that final legislation might retain stepped-up basis but lower the estate and gift tax exemption, *investors should consider making gifts this year, while the lifetime tax exemption is \$11.7M.* In the past, the IRS has not taxed (“clawed back” into the estate) gifts made in a year with a high exemption, even if the gift exceeds the exemption in effect when the donor later dies.

### *Permanent Life Insurance as a Planning Strategy*

Although not discussed at length in this paper, investors should evaluate the uses of permanent life insurance as a tax-efficient source of funds for their clients. In calling for higher tax rates, Biden’s tax plan enhances the benefits of life insurance as both an income-generating and wealth transfer planning tool.

Absent unusual circumstances, life insurance death benefits are not subject to income tax. Insurance proceeds may be used to offset or pay capital gains or estate taxes, thereby preserving the decedent’s assets for heirs. The resulting liquidity is particularly important when the estate holds illiquid assets, such as a family-owned business, real estate, or collectibles.

Certain life insurance policies also allow the owner to access the policy’s cash value as a source of non-taxable income during life. The owner may borrow against the policy without incurring income tax. *Thus, life insurance can provide income tax-free access to funds both during life and at death.*

To minimize estate tax, a life insurance policy should be purchased by an irrevocable trust, which keeps policy proceeds outside the insured’s taxable estate. A donor may fund the trust without gift tax by making a single contribution up to lifetime gift tax exemption, or by making yearly contributions up to the annual gift tax exclusion. The trust then may use these funds to pay annual premiums on the policy.

In sum, a life insurance policy held in an irrevocable trust can provide liquidity at death -- and even during life -- without the imposition of income or estate tax. The potential for an increase in taxes enhances the value of life insurance as a planning tool.

### *Conclusion*

It is uncertain whether Congress will pass tax legislation this year. In the final analysis, we believe that the Democrats will keep their caucus together and muscle through a tax bill over Republican objections. The final tax bill, however, is likely to be less extensive than Biden’s proposal.

Wealth transfer provisions will be added, changed, and removed as Congress formulates the final bill. For this reason, investors should follow the Congressional deliberations closely, and be prepared to consider the planning suggestions detailed above.

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