Advanced Markets Blog

What you need to know about potential tax increases for the wealthy

Date: 10/7/2021

There have been countless proposals circulating this year which if enacted, would result in higher taxes for high-net-worth and high-income individuals. Most recently, in September 2021, the House Ways and Means Committee released tax proposals to offset a comprehensive spending bill.

While there are still a lot of unknowns as to what may ultimately pass, financial professionals and estate planning attorneys are busy helping their clients to (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.

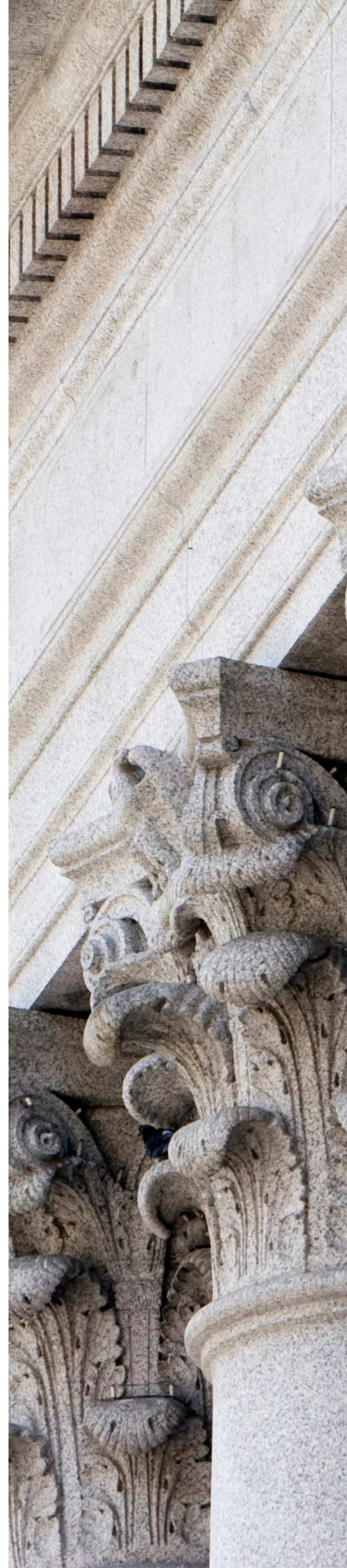
Regarding these potential tax changes, here are three key proposals being discussed and estate and insurance planning opportunities to consider for year-end:

1. Planning for income tax efficiency

The proposals

There are numerous proposals that would impact high income clients, including, but not limited to:

- Increasing the top individual income tax rate from 37% to 39.6% for single taxpayers earning over $400k AGI and married earning over $450k AGI
- Increasing the top capital gains rate from 20% to 25% for those earning over $400k
- Expanding the net investment income tax
- Imposing a 3% surtax on individuals with gross income in excess of $5M



What this means

- Clients who fall into the income tax thresholds that are proposed to increase in 2022, may want to consider accelerating income by accelerating bonuses into 2021 and/or 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 income for retirement or other long-term goals.
- Charitably inclined clients may also wish to make charitable gifts in 2021 to offset other income recognized in 2021. Under a special provision in the CARES Act, cash gifts made in 2020 and 2021 directly to qualified public charities may generally be deducted up to 100% of adjusted gross income (AGI). However, donor-advised funds do not qualify for this exception. 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.

2. Gifting exemptions before they can be reduced

Current law

Under current law, the federal gift and estate tax exemption is $10M indexed for inflation ($11.7M in 2021; $23.4M for a married couple).

The proposal

As proposed, this amount would be cut in half to a $5M exemption indexed for inflation (~$6.03M) on January 1, 2022.

What this means

- High net worth individuals may want to consider making gifts of their exemptions before they can be reduced.
- If both spouses will not fully utilize their current exemptions due to current net worth or personal cash flow needs, 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.
- When exemptions are lower there is an increased need for liquidity to pay estate taxes —which are typically due nine months after death. If gifting is being contemplated, consider discussing the benefits of using gifted assets to purchase life insurance.

3. Drafting and funding irrevocable trusts now so planning can happen quickly and/or to plan before changes to the grantor trust rules happen

Current law

An intentionally defective grantor trust (“grantor trust”) is a type of irrevocable trust that contains certain provisions or powers that cause the grantor to be treated as the owner of trust assets for income tax purposes. For estate tax purposes, assets held inside of a grantor trust are outside of the grantor’s taxable estate.

The proposal

As proposed, a new code section, IRC §2901, would cause assets in a grantor trust to be pulled back into the grantor's estate for estate tax purposes and distributions from the trust during the grantor's life and would be treated as gifts from the grantor. Gain would also be recognized on sales to grantor trusts and asset swaps would also be disallowed. These provisions would curtail the use of grantor trusts for estate planning and would also impact future transfers to grantor trusts.

What this means:

- ILITs are typically grantor trusts, because under current law, grantor trust language adds flexibility. If enacted, how ILITs are drafted would be impacted, though irrevocable trust planning with nongrantor trusts would still be possible.
- Additionally, as proposed, the grantor trust changes would be effective as of the date of enactment of the new law – meaning the new rules would apply only to future trusts and future transfers.
- Therefore, grantor trusts already in existence and promissory notes that are already in place at the time of enactment should be grandfathered. There may be a limited window to complete new trusts and gift before changes could be enacted.
- For grandfathered grantor ILITs that own life insurance policies with ongoing premiums due, loans/split dollar arrangements may be required to fund premiums after the date of enactment.

With so much uncertainty, particularly as it relates to estate planning and discussions around gifting to trusts, there are three additional strategies that may make clients more comfortable to move forward with planning.

Lock in low interest rates with "wait-and-see" loans

For clients who are on the fence about making an irrevocable gift, trust funding can be accomplished with intrafamily loans leveraging the current low interest rate environment. This approach can provide many of the benefits of outright gifting — e.g., moving appreciation out of the estate — but allows the client to decide about gifting until a later date, or not at all if they want to keep with the loan structure. Note the proposals to the grantor trust rules could impact these strategies and should be considered in discussions with the planning team.

Drafting trusts with spousal access provisions

A spousal lifetime access trust (SLAT) is an irrevocable trust that gives the trustee the ability to make distributions to the grantor's spouse during the spouse's lifetime. Although the trust may ultimately be created to benefit children, grandchildren, or charity, a SLAT allows the trustee to make distributions to the grantor's spouse should the spouse need access to trust assets. The trust can be drafted to provide distributions for health, education, maintenance or support or if necessary, can be drafted more broadly to give an independent trustee absolute discretion to make distributions of income and/or principal to the spouse. Note the proposals to the grantor trust rules could impact SLATs and should be considered in discussions with the planning team.

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

Considering the various 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 or changes to the grantor trust rules is imminent, the insured/owner can consider either of the following:

- Gifting the policy to an ILIT (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, and assuming changes to the grantor trust rules are not enacted.
- Additionally, for married couples, a "survivor standby trust" could be utilized. With this, the older spouse owns second-to-die policy and names a credit shelter (CST) under a revocable trust as the contingent owner. Presuming the older spouse dies first, the fair market value of policy included in that spouse's estate, and the CST becomes the policy owner. At the surviving spouse's death, the death benefit is paid to the CST free of estate taxes. If there is an out-of-order death or if planning needs change, the client could transfer the policy under the options outlined above.

Given the multitude of tax law changes being proposed, clients are understandably confused and concerned. Now is an excellent time for financial professionals to discuss the unique planning environment and opportunities that may be available. Now is also the time to engage other professionals – such as estate planning attorneys and valuation experts – as these individuals are likely to become inundated with requests for planning.

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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.

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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