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Biden Proposal Would Dramatically Alter Longstanding U.S. Gift and Estate Tax Planning for Wealthy Families

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In May 2021, President Biden's administration released a $6 trillion budget proposal for the coming fiscal year (''Budget''), including $3.6 trillion of tax increases over 10 years and generous tax credits to incentivize clean energy and certain infrastructure projects. The tax-related aspects of the Budget are explained in the U.S. Treasury Department's General Explanations of the Administration's Fiscal Year 2022 Revenue Proposals (''Green Book''). Included in the Budget and the Green Book are certain proposed provisions that could have a significant impact on the U.S. gift and estate tax consequences of lifetime transfers and transfers at death by high-net-worth families and individuals. The proposed federal tax revisions to the gift and estate tax provisions, as well as the potential state and local tax impact, are discussed below. In addition, we describe below how the proposals in the Green Book could create a further divergence between the Canadian and U.S. approaches to taxing the income and estate of a decedent.

BACKGROUND

By way of background, the United States imposes a gift and estate tax on (i) the worldwide assets of citizens and residents of the United States and (ii) the U.S. situs assets, including U.S. stocks and securities, of nonresident aliens (i.e., people that are neither residents nor citizens of the United States). As part of the Tax Cuts and Jobs Act (TCJA) (Pub. L. No. 115-97), signed Into law on December 22, 2017, Congress and then-President Trump made significant changes to the U.S. gift and estate tax regime impacting U.S.-based families and their worldwide assets as well as non-U.S.-based families holding U.S. situs assets. The TCJA increased the lifetime U.S. gift estate tax exemption for U.S. citizens and residents effective January 1, 2018 from $5.45 million to $11.4 million (adjusted annually for inflation) for periods beginning in 2018 and ending prior to 2026. This provision is scheduled to expire for transfers after 2025, following which, in the absence of legislation, the U.S. gift and estate tax exemption reverts to pre-TCJA levels. Amounts transferred in excess of this lifetime exemption amount generally are taxed at rates up to 40%. For nonresident aliens holding U.S. situs assets, however, in the absence of benefits under an applicable treaty, only $60,000 of U.S. situs assets can be exempt from U.S. estate tax.

The U.S.-Canada treaty (the ''Treaty'') provides some relief from the U.S. estate tax rules for Canadian residents holding U.S. situs assets in excess of the $60,000 exemption. Under the Treaty, a Canadian resident can claim an exemption from U.S. estate tax based on a pro rata portion of the full exemption available to U.S. citizens and residents based on the ratio of such person's U.S. situs assets to such person's worldwide assets.

A longstanding component of the U.S. gift and estate tax regime provides that although the donee of a lifetime transfer of property will take such property with a carryover U.S. tax basis equal to the basis of

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such property in the hands of the donor immediately prior to the transfer (thereby preserving any untaxed built-in gain for a future disposition of such property), a transfer at death generally provides the significant tax benefit of a stepped-up fair market value basis to the recipient of such property, notwithstanding that (i) no gain is triggered on the transfer and (ii) if the value of the transferred property is less than the lifetime exclusion then no estate tax is due. This stepped-up basis at death has been a key goal of the gift and estate tax planning strategies of high-net-worth families and individuals for generations.

With President Biden taking office there was an expectation (in part based on comments made during his campaign) that significant changes would be made to the U.S. gift and estate tax regime including (i) an accelerated reduction of the lifetime gift and estate tax exemption to as low as $3.5 million and (ii) an increase in the tax rate (e.g., to 45%) on transfers in excess of the lifetime exemption.

The Biden administration's intentions as detailed in the Budget and the Green Book are silent (for now) on a potential reduction in the lifetime exclusion or increase in the gift and estate tax rate; however, the Biden administration has proposed to eliminate the stepped-up basis at death through a mark-to-market tax imposed on transfers of appreciated assets as described below.

In the Canadian context, these proposals will also need to be considered by Canada-based families holding U.S. situs assets or with one or more family members who are resident in, or citizens of, the United States, including, for example, situations where the Canada-based family is considering wealth planning for transfers from the older Canadian generation to younger U.S. members of the family. Currently, the main goals of such a family upon the death of a Canadian family member are (i) protect against U.S. estate tax on the U.S. situs assets held by the decedent, (ii) provide for a U.S. tax basis step-up of the U.S. situs assets and (iii) avoid or minimize any U.S. income tax exposure. Moving forward, if the Biden proposal is enacted, these families will also need to consider the extent to which lifetime transfers or transfers at death of U.S. situs assets could trigger the mark-to-market tax and whether there are any planning techniques to mitigate the exposure.

TRANSFERS OF APPRECIATED PROPERTY BY GIFT OR UPON DEATH

As part of its effort to increase tax revenues related to the ownership of capital assets, the Biden administration has proposed that a donor or decedent must recognize unrealized appreciation in certain assets transferred by gift or upon death after December 31, 2021. Transfers of appreciated property to a surviving spouse or a charity would not be recognized and the property would be received with a carryover basis. The proposal contemplates exempting $1 million of such gain per person (adjusted for inflation after 2022), with any unused portion being portable to a surviving spouse, separately continuing to exclude a portion of such gain related to a principal residence and excluding any such gain inherent in tangible personal property other than ''collectibles.'' Presumably, the reason for the exclusion of tangible personal property is to avoid burdening families and the IRS with assessing the value of cars, clothes and other household goods not likely to appreciate, rather than gold and other valuables. These gain recognition rules would also be applied to gratuitous transfers to, and distributions in kind from, a trust, partnership, or other non-corporate entity other than a grantor trust effective January 1, 2022.

Income tax on the appreciation of interests in certain ''family-owned and -operated'' businesses could be deferred until the business is sold or is no longer family owned and operated. Tax on appreciation of illiquid assets could be paid under a 15-year fixed-rate payment plan. The IRS may require security from taxpayers to enter into such payment plans. Currently, much of this appreciation escapes income tax in the United States due to the ''stepped-up basis'' rule that resets the tax basis of assets transferred at death to the fair market value of the assets at the time of death.

The Biden proposal provides that otherwise taxable transfers will be exempt from the mark-to-market tax to the extent such transfers are made to certain qualifying transferees. For example, under the Biden proposal, transfers at death to a U.S. surviving spouse generally would not be subject to the mark-to-market tax; however, the surviving spouse will not be able to benefit from a stepped-up fair market value basis in the transferred property and will instead take such property with the decedent's basis. Although the legislation may provide clarity on this point, the language in the Green Book implies that the exemption for transfers to spouses only applies to transfers to a surviving U.S. spouse from a decedent spouse, and not to lifetime transfers from a donor spouse to a donee spouse.

The Green Book also provides an exemption for transfers from a decedent to a charity. Again, we would expect that the legislation will ultimately permit lifetime transfers to a charity to similarly be eligible for this exemption, but the Green Book language appears to limit it to transfers at death. Still unclear is the extent to which this exemption will be available to transfers to a charitable remainder trust where the grantor or the U.S. spouse of the grantor retains an interest in the transferred property.

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As more detail on the mark-to-market tax is provided through legislation, we expect to see a renewed focus on mitigating the potential U.S. tax through strategies including exemption-qualifying transfers to spouses and charities. Where a transfer is for the benefit of a non-U.S. spouse, a major consideration will be whether existing trust planning strategies used in the gift and estate tax context — such as transfers to trusts that make a so-called ''QDOT'' election (which permits a non-U.S. transferee spouse to benefit from the unlimited marital exclusion from gift and estate tax generally available to a U.S. transferee spouse) — will be available under the mark-to-market regime.

The proposal provides that the income tax imposed at death would be deductible in computing amounts subject to estate tax. With this change in place, even with the deductibility of the income tax against the estate tax, the assets of an estate, along with the unrealized appreciation in such assets, could be subject to upwards of an 80% combined effective federal and state income and estate tax. This may be compared to the maximum 26.5% rate on such assets in Canada's two largest provinces.

President Biden's mark-to-market tax proposal also contains a special valuation rule that appears to be influenced by certain U.S. estate planning techniques involving a taxpayer transferring assets to an entity and then transferring by gift a non-controlling interest in the entity out of the taxpayer's estate (for example, to an irrevocable trust). Typically, the taxpayer will reduce the gift amount with respect to the gifted entity interest by taking a valuation discount in the transferred entity interest based on the transferred interest representing a lack of control and being subject to certain transfer restrictions. Specifically, the Green Book provides that for purposes of the mark-to-market tax ''a transferred partial interest would be its proportional share of the fair market value of the entire property.'' If this proposal ultimately becomes law, it would eliminate the opportunity to apply ordinary valuation discounts when transferring minority interests, potentially creating a disconnect between the value of a minority interest for gift and estate tax purposes and the value of the same minority interest for purposes of the proposed mark-to-market tax.

ILLUSTRATING THE TAX IMPACT

Although the potential impact at the federal level alone for decedents subject to both the estate tax and the proposed tax on appreciated assets can serve as warning to high-net-worth families and individuals, for decedents domiciled in states that also have an estate tax, the impact can be downright punitive.

Although it is too early to conclude how states that impose an estate tax will react to the proposed mark-to-market tax, we have considered the potential impact under a few different scenarios.

For purposes of this discussion, we have assumed the decedent is domiciled in New York and has a gross estate consisting of $100 million of assets subject to U.S. and New York estate tax with a $0 basis. We have also assumed that Biden's proposals to tax capital gains at ordinary income rates and to increase the tax rate on individuals from 37% to 39.6% are enacted. Finally, we have assumed that any lifetime exclusions for estate tax purposes have been used and the $1 million exclusion for appreciation has been used as well.

Scenario 1: For purposes of computing the U.S. estate and the New York estate tax, a deduction is permitted for the full amount of the proposed income tax on the unrealized appreciation in the transferred assets. In addition, for purposes of calculating the U.S. estate tax, a deduction is permitted for any New York State estate taxes paid.

Under this scenario:

- The gross estate is $100 million;
- Assuming the entire $100 million is appreciation and a tax rate of 39.6% plus the net investment income tax of 3.8%, the new proposed tax on transferred appreciated assets would be $43.4 million;
- Assuming New York will permit a deduction for the transfer tax, the New York taxable estate would be $56.6 million;
- The New York estate tax, at a 16% rate, would be about $9.1 million;
- Assuming a deduction for both the federal tax on transferred appreciated assets and the New York estate tax, the federal taxable estate would be about $47.5 million; and
- Based on a federal estate tax rate of 40%, the federal estate tax would be about $19.0 million.

Based on the above, the total taxes paid on the $100 million gross estate would be about $71.5 million for an effective tax rate of 71.5%. In addition, it is currently unclear whether and to what extent the proposed federal mark-to-market tax on transferred appreciated assets could potentially flow through to a New York State or City resident's state or city tax return. If the federal tax would be imposed in such a way that it would flow through and be reported on such state or city return, that would only serve to increase the effective tax rate on the $100 million gross estate to above the 71.5% rate calculated above.

Scenario 2: This is the same as Scenario 1, except that New York State does not permit a deduction for the proposed federal income tax on the unrealized ap-

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preciation in the transferred assets. To the extent the new proposed federal tax does not flow through to a New York resident's tax return, New York would be expected to deny such a deduction (or, if it does flow through, to permit such a deduction only to the extent of additional New York taxes resulting therefrom), because the deduction would essentially cede New York taxation on a New York taxable estate to the federal government.

Under this scenario:

- The gross estate is $100 million;
- Assuming the entire $100 million is appreciation and a tax rate of 39.6% plus the net investment income tax of 3.8%, the new proposed tax on transferred appreciated assets would be $43.4 million;
- Assuming New York does not permit a deduction for the transfer tax, the New York taxable estate would be $100 million;
- The New York estate tax, at a 16% rate, would be about $16 million;
- Assuming a deduction for both the federal tax on transferred appreciated assets and the New York estate tax, the federal taxable estate would be about $40.6 million; and
- Based on a federal estate tax rate of 40%, the federal estate tax would be about $16.2 million.

Based on the above, the total taxes paid on the $100 million gross estate would be about $75.6 million for an effective tax rate of 75.6%. As noted above, it is not currently clear whether and to what extent the proposed federal mark-to-market tax on transferred appreciated assets could potentially flow through to a New York State or City resident's state or city tax return. Presumably, if it did flow through, New York would at least permit a deduction against its estate tax for any additional New York taxes resulting therefrom.

BOTTOM LINE

The bottom line is, even if one assumes that New York will not tax any of the gain deemed to be triggered for purposes of the proposed federal mark-to-market tax and permits a full deduction against the New York estate tax for such mark-to-market tax, the results are ''ugly'' in that it triggers a greater than 70% effective tax rate on a decedent's gross estate. Moreover, the extent to which (i) states tax such appreciated assets at death, either because (A) the gain deemed appreciated flows through to state returns or (B) states follow the federal government's lead and impose such tax to raise much-needed revenue or (ii) states that impose an estate tax deny a deduction for the federal tax paid on the new proposed mark-to-market tax, the numbers get even more punitive, lifting to almost 80% the effective tax rate on assets passed at death.

Moreover, in the Canadian context, Canada-based families with U.S. situs assets and U.S. family members will want to further consider the extent to which the Biden proposal can have an adverse U.S. tax impact on their wealth planning strategies. For example, such families will be further incentivized to avoid presently gifting appreciating assets to U.S. family members and beneficiaries, particularly if the intent is for such assets to continue to be owned by the family for generations to come. This provision may also discourage Canadian families from investing in U.S. situs property to the extent gain triggered on the transfer of such property would be taxable to the Canadian family member transferring the property (e.g., U.S. real property investments). Canadian families may consider various strategies, such as transfers to generation-skipping trusts and exemption-qualifying charitable transfers, while avoiding potential traps for the unwary (e.g., considering whether a typical Canadian freeze transaction could accelerate gift treatment and the resulting triggering of any gain in U.S. situs property being transferred through the freeze); however, further analysis of implementing legislation will be required to further develop planning strategies to assist U.S. — and Canada-based families in navigating this proposed mark-to-market tax.

As noted above, one of the primary planning goals for Canada-based families holding U.S. situs assets or with one or more family members that are resident in, or citizens of, the United States, is to provide for a U.S. tax basis step-up upon the death of a Canadian family member. If the mark-to-market rule becomes law, it will put additional pressure on providing for a U.S. tax basis step-up in assets before such assets are directly or indirectly inherited by U.S. heirs and enter the U.S. tax net. With proper planning, this may be achieved through certain conventional methods, including an election to treat a Canadian entity that is taxed as a corporation in Canada as a flow-through entity for U.S. tax purposes, effective prior to the death of the Canadian decedent, resulting in a deemed liquidation that can provide for a U.S. tax basis step-up in the assets held by the Canadian entity without triggering a U.S. tax (depending on the assets held by the entity and the ownership of such entity). Such planning techniques can result in a significant advantage for Canadian decedents with U.S. heirs when compared to U.S. decedents who may find it difficult to structure for a basis step-up without triggering the gain in the underlying assets.

A final point worth noting is that some consideration may be warranted as to whether there should be

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a new protocol under the Treaty to protect against potential double taxation attributable to the imposition of the mark-to-market tax, in particular upon the death of a Canadian resident holding U.S. situs property. As noted above, the Treaty provides that for purposes of determining the U.S. estate tax, Canadian residents can access that portion of the U.S. estate tax exemption equal to the ratio of such a Canadian decedent's U.S. situs property to their worldwide assets (art. XXIXB). Perhaps similar principles should be applied to permit Canadian residents to access at least a portion of the proposed $1 million exemption. In addition, some clarifying language or interpretative guidance may be necessary as to whether and to what extent Canada would permit a credit or deduction against any Canadian taxes payable by a Canadian decedent with respect to U.S. situs property held at death for any U.S. mark-to-market taxes paid by the decedent on such property. Currently, the Treaty provides a deduction for purposes of calculating the Canadian tax due at death for U.S. federal and state estate and inheritance taxes payable on such U.S. situs property.

CONCLUSION

The impact of the new mark-to-market tax proposed by the Biden administration could be immense, particularly when coupled with the proposal to tax capital gains at high ordinary income rates. Moreover, there are still many questions as to how the new tax would be implemented and whether states would provide any relief to residents subject to it or adopt a similar tax. In addition, although Biden's existing Budget and Green Book do not address the lifetime exclusion or the gift and estate tax rate, some still view those as low-hanging fruit for a subsequent budget, particularly given a push to fund many components of Biden's ambitious agenda. Also, as noted above, even in the absence of legislation, the existing $11.7 million lifetime exemption for purposes of the U.S. gift and estate tax is scheduled to revert after 2025 to the pre-TCJA level of $5.45 million (adjusted for inflation). High-net-worth families and individuals, including Canadians with significant U.S. situs assets, and their advisors, will be tracking these and future legislative proposals with great interest in order to ensure a full understanding of the potential impact on their ability to transfer accumulated wealth to the next generation without triggering arguably punitive tax bills.

Finally, it should be noted that if the above-illustrated individual were a Canadian citizen resident in Ontario or Quebec — given that the Canadian federal and provincial governments repealed estate taxes in the 1970s and replaced them with the deemed disposition at death tax that President Biden has now proposed, and given that Canada taxes only half of capital gains — the overall tax at death would be approximately 26.5%, which is roughly *one-third* of the potential effective tax rate that would be imposed at death in the United States if the proposed mark-to-market tax is enacted as set forth in the analysis above.

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