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Potential Tax Law Changes Affecting Estate Planning

After months of speculation, a more comprehensive picture of the tax aspects of the *Build Back Better Act* is beginning to emerge.

On September 13, 2021, House Ways and Means Committee Chairman Neal (D-MA) released his draft of the proposed tax portion of the Democrats' $3.5 trillion, 10-year spending plan. The proposed legislation, which is subject to negotiations and lobbying and therefore potential changes, would give rise to significant changes to the tax treatment of trusts and estates.

The proposals that would most significantly affect estate planning are:

- Changes to the tax treatment of grantor trusts, in an attempt to align the income tax rules with the estate and gift tax rules;
- An accelerated reduction of the lifetime gift and estate tax exclusion amount;
- The elimination of valuation discounts for nonbusiness assets;
- A 3% surcharge tax on trust and estate income over $100,000; and
- A reduction of Qualified Small Business Stock exemption available to trusts, estates and high-income individuals.

Proposals

<u>Grantor Trusts Rules</u>

Background

Currently, there is one set of rules for determining whether transfers to trusts are complete for estate and gift tax purposes; and there is another set of rules for determining whether a trust is a separate taxpayer or is transparent, with the grantor being the deemed owner for income tax purposes. Because of this discrepancy, it is possible to create a trust, often referred to as an intentionally defective grantor trust, which is a grantor trust for income tax purposes, but with respect to which transfers are complete for estate and gift tax purposes. This type of trust generally has two benefits: it permits grantors to bear the income tax liability with respect to trust income, thereby allowing the trust to grow unencumbered by tax (effectively enabling the grantors to make tax-free gifts in the form of income tax payments attributable to trust income); and it permits transactions between grantors and their grantor trusts without income tax consequences, thereby facilitating further estate planning transfers (including sales and grantor retained annuity trusts, or GRATs).

Proposed Changes

Changes to Transfer Tax Rules

In an attempt to align the income tax rules with the gift and estate tax rules, the proposed legislation provides that the value of a grantor trust is to be included in the grantor's gross estate for estate tax purposes. It also provides that distributions from a grantor trust (other than a distribution to the grantor, the grantor's spouse or to discharge a debt of the grantor) and the termination of a trust's grantor trust status are to be treated as taxable gifts from the grantor. Transfers previously treated as taxable gifts to a grantor trust are to be taken into account, and adjustments are to be made accordingly, in determining the amounts included in the grantor's gross estate or treated as transferred by gift under these new rules.

Changes to Income Tax Rules

The proposed legislation further provides that, in the case of a transaction between a grantor and a grantor trust (other than a revocable trust), the grantor's status as the deemed owner of the trust is to be disregarded in determining whether the transaction represents a taxable sale or exchange. As a result, certain common estate planning techniques, such as sales and asset swaps between grantors and grantor trusts, would be realization events.

Effective Date

These new rules would be applicable to trusts created after the enactment of the proposed legislation and to any portion of a trust established before the date of enactment that is attributable to a contribution made on or after the date of enactment. As is the case with all effective dates included in the proposed legislation, this date is subject to negotiation and change as part of the ongoing legislative process.

Our Take

As the legislation is now drafted, grantor trusts created prior to the date of enactment would be shielded from the modified tax treatment. Accordingly, such pre-enactment trusts would not be included in the grantor's gross estate for estate tax purposes, could continue to engage in certain transactions with the grantor without resulting in income tax recognition events, and could make distributions or turn off grantor trust status without giving rise to taxable gifts.

The new rules, however, will apply to any portion of a pre-enactment trust which is attributable to a contribution made on or after the date of enactment. The proposed legislation does not define "contribution." Presumably, the meaning will be addressed in future legislation or Treasury regulations. Absent further guidance, caution should be exercised in structuring transactions between a grantor and a pre-enactment grantor trust to ensure that any such transaction involves an exchange for fair market value. For example, certain trusts, such as insurance trusts, are established with the expectation that there will be further annual transfers from the grantor. It may be worth considering funding such trusts before enactment with sufficient funds to pay future premiums. Alternatively, further premiums might be financed via loans (provided such loans are not treated as contributions). Another issue is whether a trust modification, often achieved by appointing property in further trust (commonly referred to as a trust decanting), would constitute a contribution. Absent further guidance, care should be taken in structuring transactions between a grantor and a pre-enactment grantor trust.

Many commonly used trusts, including discretionary trusts where a spouse is a beneficiary (also known as spousal lifetime access trusts, or SLATs), life insurance trusts, GRATs and grantor charitable lead annuity trusts (CLATs), are traditionally grantor trusts. These trusts are designed to move appreciation out of the grantor's estate tax-free. While it will be possible to avoid grantor status for certain post-enactment trusts, the proposed legislation will render traditional grantor trusts (created and funded after enactment) largely unhelpful as estate planning tools.

Reduction in Exclusion Amount

Background

The applicable exclusion amount from gift and estate tax currently is $11.7 million per taxpayer, and is, under current law, set to revert to a reduced amount of $5 million per taxpayer, adjusted for inflation, effective January 1, 2026.

Proposed Changes and Effective Date

The proposal accelerates this reduction for gifts made and estates of decedents dying after December 31, 2021.

Our Take

While taxpayers have until the end of 2021 to use their full exemption amount, the proposed changes to the grantor trust rules provide that such gifts (to grantor trusts) must be made prior to the enactment of the proposed legislation. As a result, if a taxpayer wishes to use his or her full exemption by making a gift to a new or existing grantor trust, the timeline must be accelerated.

Elimination of Valuation Discounts

Background

The current transfer tax system determines tax liability based on the fair market value of the property transferred. Fair market value, in turn, is the price at which the property would change hands between a hypothetical willing buyer and a hypothetical willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of the facts. Under this definition, valuation discounts that represent lack of marketability or lack of control are permissible.

The Treasury Department has previously attempted to address the perceived abuse associated with the use of valuation discounts. In 2016, the Treasury Department issued proposed regulations under Section 2704 which applied in situations where the members of the same family controlled the enterprise. Commentators were highly critical of the proposed regulations as unduly burdensome and complex, and ultimately they were withdrawn.

Proposed Changes

The proposed legislation eliminates valuation discounts for transfers of certain nonbusiness assets. Nonbusiness assets are defined as passive assets held for the production of income and not used in the active conduct of a trade or business. If a passive asset is itself a 10-percent or greater interest in another entity, a look-through rule will apply, and this asset will be ascribed the value of its pro rata share of the other entity's assets.

Real property used in the active conduct of a trade or business will not be considered a passive asset, provided that the transferor materially participates in the business.

Effective Date

This provision is effective for transfers after the date of enactment.

Our Take

The proposed legislation marks a significant shift from current valuation rules and from previous attempts at curtailing valuation discounts. The Treasury Department's previous proposed regulations took aim at valuation discounts with respect to interests in family-controlled entities. By comparison, the proposed legislation would extend to a wider class of assets, without regard to whether there is family control.

The new rules create uncertainty. For example, many existing GRATs have been funded with discounted assets. It is unclear whether post-enactment in-kind annuity payments from such a GRAT would be valued without regard to discounts. It seems unlikely that this outcome, which would result in greater appreciation passing out of the grantor's estate, is intended under the proposed legislation.

Taxpayers who otherwise intend to make transfers of membership interests in family entities or operating businesses with passive assets should consider making these transfers before enactment.

Additional 3% Surcharge

Background

Trusts and estates are currently taxed at compressed tax brackets, in order to inhibit shifting of income to taxpayers in lower tax brackets. For tax year 2021, trust or estate income over $13,050 is taxed at 37%.

Proposed Changes

The proposal would impose a 3% surcharge tax on the gross income in excess of $100,000 for a trust or estate, $2,500,000 for a married individual filing a separate return, and $5,000,000 for any other taxpayer.

Effective Date

This provision is effective for tax years beginning January 1, 2022.

Our Take

Generally speaking, non-grantor trusts and estates are separate taxpayers. Unlike an individual taxpayer, a non-grantor trust or estate receives a deduction for distributions, subject to certain rules. The beneficiary who receives a distribution, in turn, has income inclusion. The income tax rules for estates, trusts and beneficiaries generally give rise to one level of income tax, either at the trust (or estate) level or the beneficiary level, or a mixture of both, depending on whether there are distributions and the amount of distributions.

Under the proposed legislation, a trust would incur a surcharge tax on all income in excess of $100,000, whereas a trust's beneficiary would only incur this surcharge on income in excess of $2,500,000 or $5,000,000, depending on his or her filing status. These rules will put additional pressure on trustees to consider making distributions that will reduce the trust's resulting income and enhance the beneficiary's income. While the applicability of state income tax and other non-tax considerations will need to be taken into account, distributions to individual beneficiaries under the surcharge threshold may reduce the impact of this 3% surcharge.

Available Qualified Small Business Stock Exclusions

Background

Current rules provide significant benefits to taxpayers holding qualified small business stock (QSBS).

In order for stock to qualify as QSBS, the taxpayer must have acquired it at its original issue from a C-corporation with less than $50 million in gross assets. Taxpayers who have held QSBS for at least five years can avail themselves of a 50%, 75% or 100% exclusion of gain on a subsequent transfer or sale, depending on when the QSBS was initially acquired.

Taxpayers may exclude an amount of QSBS gain from each issuer not to exceed the greater of $10 million or ten times the aggregate adjusted bases of the QSBS disposed of by the taxpayer.

Proposed changes

The proposed legislation eliminates the availability of the 75% and 100% exclusions of QSBS gain for all trusts and estates, as well as individual taxpayers with adjusted gross income above $400,000.

Effective Date

This amendment would apply to sales and exchanges made on or after September 13, 2021.

Our Take

While this proposal would significantly reduce the tax benefits attributable to QSBS, it nevertheless maintains a separate exclusion for trusts and estates. Accordingly, having non-grantor trusts as shareholders still could offer enhanced QSBS tax benefits, provided that the trusts are not aggregated under the Internal Revenue Code.

What is Not Included

Significantly, the proposed legislation does not include many of the proposals included in President Biden's proposed Fiscal Year 2022 budget, commonly known as the Green Book, including:

- Deemed realization upon the transfer of appreciated assets;
- Deemed realization upon the death of the owner of appreciated assets;
- Deemed realization upon in-kind distributions of appreciated assets from trusts, partnerships or non-corporate entities, other than distributions from revocable trusts to the grantor or grantor's spouse; and
- Deemed realization on appreciated assets held within trusts, partnerships and other non-corporate entities every 90 years, regardless of whether the trust engaged in a transaction with these assets.

Support for the elimination of the step-up in basis at death also appears to be waning, though the Senate Finance Committee, which is drafting its own bill, has indicated that it still considers this proposal in play.

Finally, more far-reaching progressive proposals also are absent. Senator Warren has proposed a tax on the net worth of wealthy individuals and trusts. Senator Sanders has proposed a significant increase in estate tax rates. Senator Wyden has proposed a mark-to-market regime, which would impose tax liability on accrued, rather than realized, capital gains. These proposals are not part of the legislation advanced by the Ways and Means Committee.

Legislative Process and Timing

Having marked up Chairman Neal's proposed legislation on September 14th and 15th, the House Ways and Means Committee advanced the text to the Budget Committee. The Budget Committee will compile the recommendations from all committees and panels and report this full reconciliation bill to the chamber.

In the Senate, the resulting reconciliation bill will be considered under expedited procedures that limit debate and amendments. The reconciliation bill will not be subject to filibuster and the scope of amendments will be limited to policies that change spending or revenue. Once differences between the House and Senate versions of the bill are resolved, the bill will be presented to President Biden.

There is no firm indication of how long this legislative process will take. However, Democratic leadership previously committed to holding a vote on the infrastructure bill by September 27th, in a gesture to appease centrist Democrats. The party's progressive wing, on the other hand, has indicated that they will vote against the infrastructure bill on September 27th if the reconciliation bill does not move alongside it. Accordingly, there is significant pressure to move forward with the reconciliation bill in a timely manner. Yet there remain serious disagreements among Democrats regarding aspects of the bill. Some Democrats have publicly opposed drug pricing plans included in the current bill, while others have insisted on revoking the limitation on SALT deductions (which in turn would require additional sources of revenue). Some members oppose the size of the spending plan entirely. With such a narrow majority, Democrats will need to reach a broad consensus among their members in order to proceed.

Next Steps

The tax proposals represent a fluid situation. There will be significant efforts by interested parties to encourage modifications. Furthermore, given the narrow Democratic majority in the House and Senate, the Democrats will have to find common ground in order to enact legislation. It remains unclear as to whether there will be new tax legislation, and if so, what it ultimately will look like.

Despite such uncertainty, proposed changes have begun to coalesce in the form of the proposed legislation advanced by the House Ways and Means Committee. If you are considering using your estate and gift tax exemption or creating grantor trusts, we encourage you to reach out to us as soon as possible.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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