Proposed Legislation Drastically Changes Estate Planning Landscape

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On September 27, 2021, the Build Back Better Act (the "Act"), was introduced in the House of Representatives. Although negotiations are ongoing, if the Act or legislation similar to the Act is enacted, it will substantially impact gift, estate and trust planning. As proposed, many of the changes could be effective as of the date of the law's enactment, so it is imperative that you review and assess your estate plan as soon as possible. A brief overview of the currently proposed changes that most impact estate planning are as follows:

Decrease in Estate, Gift and Generation Skipping Transfer ("GST") Tax Exemption Amount.

Current law. For U.S. citizens and domiciliaries, until 2026, the gift, estate, and GST tax exemptions are each $10 million per person, indexed for inflation (in 2021, the exemptions are $11.7 million). Generally, for married couples, this amount is essentially doubled.

Proposed change. The Act would reduce these transfer tax exemptions to $5 million per person, indexed for inflation, after December 31, 2021. Like current law, this amount would generally be doubled for married couples.

Planning to consider. Because these exemptions will roughly be cut in half as of January 1, 2022, you may wish to explore using the current higher exemptions by making gifts before year-end, or allocating GST exemption to trusts which are not currently GST exempt.

Grantor Trust Taxation.

Current law. For income tax purposes, property in a grantor trust is essentially treated as the property of the

grantor. As a result, the income and deductions associated with grantor trust assets are reported on the tax return of the grantor. However, if properly structured, the property in a grantor trust can be deemed to be out of the grantor's estate for estate tax purposes (this is an "Intentionally Defective Grantor Trust" or "IDGT"). IDGTs allow a grantor to transfer assets indirectly to beneficiaries of the IDGT in a very transfer tax friendly manner. The grantor uses a portion of his/her/their estate and gift tax exemption to make a gift of property to the IDGT removing such property and all future appreciation on that property from the grantor's estate. The grantor's payment of the IDGT's income tax liability acts as an additional gift to the IDGT without any further reduction in the grantor's estate and gift tax exemption. Furthermore, the fact that the trust itself is not paying the income tax liability allows the assets in the trust to grow at a more rapid pace. For these reasons, IDGTs have been a favored tool of estate planners for many years.

Additionally, under current law, sales or transactions between the grantor and his or her grantor trust are generally not recognized for income tax purposes, meaning that a grantor can sell or swap assets to his or her grantor trust without income tax consequences.

Proposed change. The following changes would generally effect grantor trusts created on or after the date of enactment and to existing trusts to the extent "contributions" (which is not defined) are made to such trusts on or after the date of enactment:

- Estate Tax Inclusion: Assets owned by a grantor trust would be included in the grantor's estate and subject to estate tax upon the grantor's death.
- Distributions as Gifts: Distributions to someone other than the grantor, the grantor's spouse, or to discharge a debt of the grantor from a grantor trust during the grantor's lifetime would generally be treated as taxable gifts.
- Taxation Upon Termination of Grantor Trust Status: If the trust's grantor trust status is terminated (*i.e.*, the trust becomes a separate taxpayer from the deemed owner), the grantor would be deemed to have made a taxable gift of the trust assets.
- Gain Recognized Upon Sale to Grantor Trust: Sales and other transactions between a grantor trust and its grantor would be subject to income tax.

Planning to consider. If enacted, certain traditional lifetime estate tax planning tools, including IDGTs, Irrevocable Life Insurance Trusts ("ILITs"), Qualified Personal Residence Trusts ("QPRTs"), and Grantor Retained Annuity Trusts ("GRATs"), will no longer be attractive. Accordingly, if appropriate for your circumstances, these types of planning strategies should be implemented now. In addition, the ongoing treatment of existing (or soon-to-be formed) grantor trusts should be assessed – for example, it may make sense to fully-fund an ILIT with all expected premium payments before the date of enactment.

Limitation on Valuation Discounts.

Current law. When valuing interests in entities for transfer tax purposes, certain discounts for lack of marketability and lack of control may be available, depending on the specifics of the entities involved. Any discounts taken should be supported by an appraisal. The result is the value of the asset is lowered for estate and gift tax purposes, so the amount of exemption used is minimized.

Proposed change. The Act would require a two-part valuation analysis of entities, applicable to transfers after the date of enactment. First, any "non-business assets" (passive assets held for the production of income and not used in connection with the active conduct of a trade or business) owned by the entity are valued as if they were transferred by the donor/transferor directly, disallowing valuation discounts. Next, the remaining interest in the entity transferred is valued using the traditional "willing buyer-willing seller analysis," but the value of the non-business assets are ignored.

Planning to consider. To the extent you are considering making gifts or other transfers of entity interests, it may be appropriate to accelerate that planning so that the transfer is concluded before the enactment of the Act, in order to utilize the more robust valuation discounts.

Estate and Non-Grantor Trust Federal Income Tax, Capital Gains Tax and Surcharge Rates.

Current law. The top federal income tax rate for estates and non-grantor trusts is currently 37%, and the top federal capital gains tax rate is 20%.

Proposed change. The top federal income tax rate for estates and non-grantor trusts would increase to 39.6% and the top federal capital gains tax rate would increase to 25%. A 3% tax surcharge on modified adjusted gross income (which includes ordinary and capital gains income) over certain limits would also apply. Importantly, these higher rates and surcharge apply at much lower thresholds for estates and non-grantor trusts than for individuals and grantor trusts. For example, the 3% surcharge would apply to estates and non-grantor trusts on taxable income in excess of $100,000 (as opposed to $5,000,000 threshold for individuals), and estates and non-grantor trusts would

be taxed at 39.6% on taxable income in excess of $12,500 (adjusted for inflation) (as opposed to the $450,000 threshold for married couples filing jointly).

These changes would mainly apply after December 31, 2021, but the change to the federal capital gains tax rate would have a retroactive application to September 13, 2021 as currently proposed.

Planning to consider. Existing structures should be reviewed for optimal tax efficiency going forward.

What Has Been Omitted.

Certain other changes were anticipated, but to date, have not yet been included in the Act. The maximum estate and gift tax rate has not been increased and remains at 40%. There are no proposed changes to the GST tax or to the treatment of dynasty trusts. The gift tax exemption remains unified with the estate tax exemption. No changes to the gift tax annual exclusion are included. Importantly, the proposed legislation does not include any provisions triggering capital gains tax when a gift is made or upon the death of a taxpayer, nor are there any changes to the step-up in basis rule at death.

Conclusion.

Although it is subject to change, we now have specific legislation to consider when implementing year-end estate and gift tax planning. Many of the proposed changes are significant, and would impact traditional, time-honored estate planning strategies. There is still time to consider your circumstances and to take whatever action best serves your overall planning goals.

For additional information on the impact of the proposed legislation, please contact Stephen J. Pagano at spagano@riker.com or Lauren N. Spitser at lspitser@riker.com.

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