Proposed Changes to Income and Transfer Taxes –

A Brief Summary of the Estate Planning Changes in the New $3.5 Trillion Infrastructure Proposal

In late August 2021, by a 220 – 212 party-line vote, the House of Representatives passed a $3.5 trillion budget resolution,[1] while also advancing the $1 trillion bipartisan infrastructure bill.

On September 13, 2021, House Ways & Means Committee Chairman Richard E. Neal (D-MA) released the initial legislative text and a summary of the proposed "Build Back Better Act" (the "Proposal"). On September 15, 2021, the Committee approved its sections of the Proposal that mostly addressed social issues and plans to pay for them with tax increases. The Proposal contains provisions that, presumably, seek to increase taxes on the higher income and high net worth taxpayers.

The focus of this Client Alert is on estate planning changes, which include increasing ordinary income and capital gains tax rates for high income earners, lowering transfer tax exemptions, subjecting certain irrevocable grantor trusts to the estate tax, and attempting to overhaul the "grantor trust" income tax rules.

We Cannot Emphasize This Enough - This is Only PROPOSED Legislation!

Before we present our summary, it is important to note that, at this time, *these changes are only legislative proposals – they are NOT THE LAW!*

We note that some Democrats cautioned that the Proposal would likely change – perhaps considerably – as President Biden's economic agenda wends its way through the House and Senate.[2] Further, Sen. Ron Wyden (D-OR), the Chairman of the Senate Finance Committee, was quoted as stating, "It would be a monumental mistake for Congress to pass a bill that really exempts billionaires."[3] Additionally, prior to the public rollout of the Proposal, Sen. Joseph Manchin III (D-WV), in an Op-Ed in the Wall Street Journal and on NBC's "Meet the Press,"[4] and Sen. Kyrsten Lea Sinema (D-AZ), as quoted in "Business Insider,"[5] both indicated that they would not likely support a $3.5 trillion bill. Further, Chairman Neal states that the markup is complex and will be "shaped and crafted continuously to get it right," specifically referring to potential relief of the state and local tax limitation (which is not in the Proposal, which we discuss below).[6]

Our Objectives with this Alert

With this alert, our goal is to provide you with information that hopefully allows you to make the best informed decisions for you and your families as to what may happen with the Proposal. In the following discussion, we will provide an unbiased, apolitical and neutral approach toward the proposed legislation. We realize that it is possible that some of our statements, although not intended, **<u>may</u>** be viewed as political

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[1] A 'budget resolution" is the federal government's blueprint for raising revenues and directing spending. It provides committees (such as the House Ways & Means Committee and the Senate Finance Committee) with general instructions on what tax laws changes are necessary to accomplish the budgetary plans. Importantly, it is non-binding. It must be agreed upon by both chambers. The $1 trillion budget resolution was agreed upon by both the House and Senate in August 2021. The $3.5 trillion budget resolution was passed only in the House. As discussed in this Client Alert, the Senate will have to agree upon the $3.5 trillion budget resolution for it to be advanced further.

[2] Jonathan Weisman and Jim Tankersley, *House Democrats' Plan to Tax the Rich Leaves Vast Fortunes Unscathed*, NEW YORK TIMES (September 13, 2021).

[3] <u>Id.</u>

[4] Joe Manchin, *Why I Won't Support Spending Another $3.5 Trillion*, WALL STREET JOURNAL (September 2, 2021); *see also* <u>Meet the Press</u>, NATIONAL BROADCASTING COMPANY (aired September 12, 2021).

[5] Joseph Zeballos-Roig, *Biden's $3.5 Trillion Economic Plans See Big Cuts as Moderate Sen. Kyrsten Sinema Doubles Down in Opposition to Cost*, BUSINESS INSIDER (August 23, 2021).

[6] *House Tax Writing Committee Approves Revenue Portion of the $3.5 Trillion Infrastructure Bill,* THOMPSON REUTERS/TAX & ACCOUNTING, FEDERAL TAX UPDATES, September 16, 2021.

statements. We wish to state that no such political statements are intended and nor should any portion of this alert be considered as any such statements.

Significant Estate Planning Proposals

While reviewing the summary, it is important to note the effective date is not the same for all of the proposed provisions. The effective dates vary and are typically one of three dates: (1) the first day of the succeeding calendar year (e.g., January 1, 2022); (2) the date that the legislation becomes law (i.e., the "Enactment Date"); or (3) the date following the date the legislation is introduced for consideration (i.e., the "Introduction Date," which appears to be September 13, 2021, but, at this point in time, it is unclear whether that will be the date).[7] In discussing a particular provision, we will indicate when the effective date would be, if the provision, as currently proposed, became law.

Estate, Gift and GST Tax

Possible changes to the estate, gift and generation-skipping transfer (GST) taxes are as follows:

- **Estate, Gift and GST Tax Exclusion Amount Reduction**. The Proposal cuts the estate and gift tax exclusion amount, and the GST tax exemption amount, from the current $10 million plus a cost-of-living adjustment (COLA) (for 2021, the inflation-adjusted exclusion and exemption amounts are $11.7 million) back to $5 million plus the COLA.[8] If this provision is enacted, then, for 2022, the inflation-adjusted exclusion and exemption amounts are each projected to be $6,030,000.[9]

  This provision, if enacted, would be effective as of January 1, 2022.[10]

- **Curbing the Use of Irrevocable Grantor Trusts in Estate Planning**.[11] A key component in many estate plans is the use of an irrevocable "grantor trust" (IGT), which contains provisions causing the IGT's income and deductions to be reported on the grantor's income tax returns – in other words, for income tax purposes, the grantor is deemed to own the IGT's assets. A major advantage of this treatment is that the IGT could purchase assets from the grantor without the purchase being treated as a sale for income tax purposes – there would be no gain to report. This occurs because, for income tax purposes, the grantor is deemed to own the IGT's assets and an individual cannot have a taxable exchange with herself/himself. Further,

[7] In reading the Proposal, it is not clear as to what date is the Introduction Date. We believe that the date is September 13, 2021 as this date is referenced in at least two specific provisions in the Proposal, namely, the increase in the capital gains rate and the changes with qualified small business stock. The issue, though, is whether the date of the release of the Proposal by the House Ways & Means Committee is actually the Introduction Date, or will the Introduction Date mean some other date, such as the date that the Proposal is introduced to the full House of Representatives for consideration. Assuming that the Proposal passes out of the House Ways & Means Committee, this confusion will likely be clarified.
[8] In 2010, the lifetime exclusion was temporarily increased from $3.5 million to $5 million plus the COLA. In 2012, this provision was made permanent. The 2017 Tax Act doubled the $5 million plus the COLA to $10 million plus the COLA. The Proposal seeks to reverse the increase from the 2017 Tax Act.
[9] *See* Inflation-adjusted 2022 figures for transfer tax and foreign items, THOMSON REUTERS RIA FEDERAL TAX UPDATES (September 14, 2021), calculated by dividing the projected 2022 amount under current law in half.
[10] Note that this change, if enacted, would effectively accelerate the "sunset" of the exclusion and exemption amounts which was to occur on January 1, 2026.
[11] Under current law, irrevocable grantor trusts (IGT) offer many benefits, which include, but are not limited to, the following: (a) the grantor can make gifts to the IGT during lifetime and, if properly structured, the trust (including any future appreciation or growth in value) escapes estate taxation upon the grantor's death; (b) the grantor's payment of the income tax on the trust's income is not a gift for gift tax purposes, which allows the trust property to grow free from the burden of income tax; (c) the IGT could purchase assets from the grantor without the purchase being treated as a sale for income tax purposes – there would be no gain to report; (d) if the purchase occurred through the use of a promissory note, and if the purchased asset appreciates at a rate in excess of the interest rate on the note, the excess appreciation escapes estate taxation upon the grantor's death, and the interest paid on the note is ignored for income tax purposes; (d) the grantor could also reacquire appreciated trust assets in exchange for higher basis assets and this can be achieved tax-free; (e) the IGT would be automatically qualified to own stock in an S Corporation; and (f) the IGT can use the social security number of the grantor for tax reporting purposes and no separate income tax return is needed during the grantor's lifetime.

under existing law, if the IGT is properly structured, the provisions causing the IGT to be a "grantor trust" only affect the IGT for income tax purposes – such provisions do not disturb the rules that allow the IGT to escape estate taxation upon the grantor's death.

Under the Proposal, it appears that IGTs created and funded *after* the Enactment Date would be subject to estate taxes upon the grantor's death, and IGTs that were created and funded *before* the Enactment Date will be exempt from this new rule (i.e., they will be grandfathered and still escape estate taxation upon the grantor's death). Additionally, for existing grandfathered IGTs, it appears that the portion of the trust representing new contributions made after the Enactment Date would, however, be subject to estate taxation upon the grantor's death.

If this provision passes, the result will be a major disruption to a long-standing and core estate planning strategy. By example, this far-reaching provision has the potential of affecting almost all inter-vivos irrevocable trusts where the trust's grantor is living, which includes life insurance trusts (where contributions are made annually). What is not entirely clear is the tax treatment of existing installment sales and/or future installment sales to grandfathered IGTs.

This provision, if enacted, would be effective on the Enactment Date.

- **<u>Eliminate Discounts for Transfers of Closely-Held Non-Business Assets</u>**. Another key component of many estate plans is the use of valuation discounts on the transfer of closely-held assets. If an individual owns a partnership interest that is not publically traded and does not have voting control, it is unlikely that a third-party purchaser would purchase the interest for its liquidation value (i.e., the partnership interest's *pro-rata* value of the underlying assets in the partnership). Rather, a third-party purchaser may purchase the interest, but would want a discount from the liquidation value. The use of valuation discounts in determining the gift or estate tax value of a closely-held interest has resulted in a constant struggle between taxpayers and the IRS in determining exactly what discount is applicable to a particular interest.

  Under the Proposal, such valuation discounts on transfers of closely-held non-business assets are eliminated in determining the asset's value for gift and estate tax purposes. "Non-business assets" are described predominantly as passive-type assets (i.e., assets in which the partners are not conducting an actual trade or business). This provision is designed to curb the strategy of creating "family limited partnerships" to hold passive assets (i.e., a portfolio of stocks, bonds, mutual funds, and like type assets), and have the partnership valued for gift and estate tax purposes at a lesser value due to discounts for lack of marketability and minority interests.

  This provision, if enacted, would apply to transfers after the Enactment Date.

Certain changes that were heavily discussed prior to the release of the Proposal and that were *not* included in the Proposal include:

- **<u>No Retroactivity of Exemption/Exclusion Reduction</u>.** Up until the Proposal's release, practitioners worried whether any potential reduction in the exclusion/exemption amounts in 2021 would be retroactive to January 1, 2021 or some other date. The Proposal does *not* contain a retroactive provision, meaning that, even if the Proposal is passed into law before January 1, 2022, gifts could still be made using the 2021 exemption/exclusion amounts.

- **<u>Dynasty GST Trusts Remain Unscathed</u>.** Before the Proposal's release, there was concern that trusts would be subject to the GST tax if they lasted beyond 90 years from creation (i.e., "dynasty trusts"). The Proposal does not contain this change. Moreover, the Proposal makes no changes to the GST tax (other than the reduction of the GST exemption).

- **<u>Transfer Tax Rates Not Affected</u>.** There was also concern that the transfer tax rate (currently 40% for each of the estate, gift and GST tax) would increase. There is no mention in the Proposal about increasing the rate (i.e., the rates would stay at 40%).

- **No Limitation on Annual Exclusion Gifts**. Under IRC §2503(b), any individual can give up to $15,000 each year to any other individual without such gift being considered to be a taxable gift. Currently, there is no limit on the number of individuals to whom the $15,000 may be given. In other words, the focus of the "annual gift tax exclusion" is as a "per-donee" exclusion. Some of the prior bills had proposed a collective annual exclusion amount such that the focus would be a "per donor" exclusion, meaning that an individual could only gift $x per year, regardless of the number of donees to whom the donor gifted assets. No such provision is in the Proposal.

Income Tax

The following are some of the proposals that, if passed, would affect higher-income earners:

- **Sales to Irrevocable Grantor Trust**. In the Estate Tax section above, we highlighted the potential of IGTs being subject to estate taxation upon the grantor's death. The proposed changes to the treatment of IGTs are not just limited to the transfer tax provisions. The Proposal reshapes the "grantor trust" rules such that sales between the grantor and the IGT, which are ignored under current law, would be deemed to be taxable events (i.e., triggering income taxes) if this provision is enacted.

  This provision, if enacted, would be effective on the Enactment Date. However, as discussed above, it is not clear if this proposed change would apply to post-enactment sales to a grandfathered IGT.

- **Capital Gains Tax Rate Increase**. Under the Proposal, the capital gains tax rate is increased from 20% to 25% for higher income earners (i.e., single filers with taxable income in excess of $400,000 and married couples with income in excess of $450,000).

  This provision, if enacted, would be effective for taxable years ending after September 13, 2021 (which, for 2021, would result in two sets of calculations – one for gains incurred on or before September 13, 2021, and one for gains incurred after September 13, 2021).

- **Ordinary Income Tax Rate Increase**. The Proposal provides for an increase to the highest marginal ordinary income tax rate from 37% to 39.6% (i.e., the top rate prior to the tax cuts from the 2017 Tax Act) for higher-income earners (i.e., single filers with taxable income in excess of $400,000 and married couples with income in excess of $450,000). For trusts and estates, the highest rate would be applicable for income over $12,500.

  This provision, if enacted, would be effective January 1, 2022.

- **Expand the Net Investment Income Tax**. Under the Proposal, the 3.8% net investment income tax (which was created upon the passage of the Affordable Care Act) is expanded to include income from trade or businesses for higher-income earners (i.e., single filers with taxable income in excess of $400,000 and married couples with income in excess of $500,000).[12]

  This provision, if enacted, would be effective January 1, 2022.

- **New 3% Surtax on Income over $5 Million**. The Proposal provides for the imposition of a new 3% additional tax on the highest of income earners (i.e., taxpayers with over $5 million of "modified adjusted gross income").[13]

  This provision, if enacted, would be effective January 1, 2022.

[12] The Proposal clarifies that it would not affect "W-2" type income (because that income is already being taxed with an equivalent tax (i.e., the FICA tax)).
[13] "Modified adjusted gross income" generally means adjusted gross income but adding back any offsets for investment interest expense.

- **<u>Carried Interest</u>**. A common asset for many institutional or hedge fund managers is the "carried interest" component in a particular fund or equity investment. Under the Proposal, the holding period for "carried interest" changes from 3 to 5 years.

  This provision, if enacted, would be effective January 1, 2022.

- **<u>Modify Qualified Small Business Stock Exclusion</u>**. When the 2017 Tax Act cut the corporate tax rate from 35% to 21% and eliminated the corporate alternative minimum tax, investments in certain "qualified small business stock" and its special exclusion of certain gains provided certain investors with ways to lower their overall tax rate. The Proposal modifies this special exclusion, reducing the 75% and 100% exclusion rates for taxpayers with gross income of $400,000 or more, and allowing the 50% exclusion for such higher-income taxpayers.

  With an exception for binding contracts, this provision, if enacted, would be effective for sales or exchanges occurring on or after September 13, 2021.

- **<u>Wash Sales Apply to Digital Assets</u>**. Because the IRS classifies digital currencies like bitcoin (i.e., "cryptocurrency") as "property," losses on cryptocurrency are treated much differently than losses on stocks and mutual funds. Particularly, the "wash sales" rules are not applicable to cryptocurrency,[14] which means that cryptocurrency can be sold at a loss and immediately repurchased without jeopardizing the recognized loss. The Proposal enlarges the "wash sale" rules to capture not only marketable securities, but also cryptocurrency.

  This provision, if enacted, would be effective January 1, 2022.

- **<u>Limit the New 199A Deduction</u>**. Under IRC §199A, certain taxpayers other than corporations are entitled to deduct 20% of qualified business income earned in a qualified trade or business, subject to certain limitations. The Proposal limits the Section 199A deduction to $500,000 in the case of a joint return, $400,000 for an individual filer, $250,000 for married filer filing separately, and $10,000 for trusts and estates.

  This provision, if enacted, would be effective January 1, 2022.

- **<u>IRA Provisions</u>**. On the heels of the SECURE Act, which changed the timing for the payout of Individual Retirement Accounts (IRAs) upon death, the Proposal includes further changes for IRAs. In particular, the Proposal changes some of the rules for IRAs (both traditional and Roth IRAs) and defined contribution retirement accounts, including:
  - IRA contributions would be prohibited if the value at the end of the prior year of all of the taxpayer's IRAs exceeds $10 million. The limitation applies to individuals with income over $400,000, married couples filing jointly with income over $450,000 and heads of households with income over $425,000 (defined as "High Income Taxpayers").
  - If, at the end of a particular year, an individual is defined as a High Income Taxpayer, and if the individual's combined IRA value exceeds $10 million at the end of said year, then, regardless of the individual's age, a minimum distribution would be required in the following year of an amount equal to 50% of the amount by which the combined IRA value exceeded the $10 million threshold.
  - For High Income Taxpayers owning IRAs with a combined value in excess of $20 million, there would be more significant required minimum distributions.
  - The Proposal further limits conversions from traditional to Roth IRAs based on income thresholds.

[14] A "wash sale" is when securities are sold at a loss, and then, within 30 days before or after the sale, substantially identical securities are acquired.

- The Proposal adds various administrative provisions that would disallow certain investments in IRAs.

Most of the IRA provisions, if enacted, would be effective January 1, 2022.[15]

What Surprisingly was Not Included in the Proposal

Interestingly, many proposals from other previously introduced bills or proposals are not included in the Proposal.[16]

- **<u>Step Up At Death</u>**. When an individual dies, the cost basis in an asset (i.e., the amount used to determine the gain/loss on the disposition of the asset) included in the individual's estate receives a "step up" to the asset's fair market value at the time of the individual's death. While campaigning, President Biden proposed to limit the "step up" to a fixed amount of $x, which would be allocated among various assets by the decedent's executors.[17] The Proposal does not include any provision to eliminate the step-up in basis.
- **<u>Income Tax on Unrealized Gain at Death</u>**. Another proposal during President Biden's campaign was to tax all appreciated assets upon an individual's death (which is the system generally in effect in Canada). No such provision is contained in the Proposal.
- **<u>Removal of the SALT Deduction Limitation</u>**. As part of the 2017 Tax Act, the amount deductible for the payment of state and local taxes (the "SALT" deduction) was capped at $10,000. The limitation affected many taxpayers in the more populated states where property tax rates are considered to be high, such as New York, New Jersey and California. No provision for the SALT deduction is included in the Proposal. However, Chairman Neal was quoted yesterday as stating that, "we are committed to enacting a law that will include meaningful SALT relief."[18]

A Proposal That Surprised Us Regarding Certain Subchapter S Corporations ("S Corporations")

Under current law, if an S Corporation wants to reorganize and become a partnership for income tax purposes, generally, this is a taxable event. A provision in the Proposal benefits owners of "eligible S Corporations" by allowing them to reorganize the S Corporation as a partnership and avoid any gain-recognition on the conversion. The Proposal defines an "eligible S Corporation" as any corporation (including any predecessor corporation) that was an S Corporation on May 13, 1996.

This provision, if enacted, would be effective as of January 1, 2022.[19]

A Necessary Proposal for Tax Enforcement

Under the Proposal approximately $80 billion is set aside for the IRS with a small portion going to the Tax Court, which includes allocating funds to update technology and human capital necessary to support enforcement activities. Putting this amount in perspective, this is roughly ¼ of one percent (0.0023) of the proposed costs under the Proposal.

Planning Suggestions

If the Proposal is enacted in its current form (which, as we stated above, would seem highly unlikely, but if it did…), many of the provisions in the Proposal – especially the income tax proposals - would not become

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15 However, some of the provisions, such as the investment prohibition, would have a two-year phase-in provision if the IRA held what would then be considered to be a prohibited investment.
16 It is important to note that just because a provision is not included in the Proposal does not mean that it may not later be added after further debate and discussion; however, historically it has been rare that a rejected tax proposal would be reintroduced at a later time.
17 See, Taylor Tepper, *Stepped Up Basis Reform: Biden's Middle Class Tax Hike?* Forbes, May 7, 2021. *See also* Rocky Mengle, *Biden Hopes to Eliminate Stepped-Up Basis for Millionaires*, Kiplinger, April 28, 2021. Note that the concept of allocating a specific dollar amount among assets in the estate was the optional procedure in effect for decedents who died in 2010.
18 *See* <u>House Tax Writing Committee Approves Revenue Portion of $3.5 Trillion Infrastructure Bill</u>, THOMSON REUTERS RIA FEDERAL TAX UPDATES (September 16, 2021).
19 There would be a two-year window for this opportunity.

effective until 2022. The decrease to the gift and estate tax exclusion and GST exemption would also not take effect until 2022. This creates a period for possible tax planning in advance of the possible impending changes.

For example, if you desire to make gifts utilizing your remaining gift tax exclusion and/or GST exemption amounts but have been worried about the potential for retroactivity, the Proposal may provide you with sufficient comfort to proceed with the gifts before the end of 2021. If the strategy is one of the more complex strategies, such as a sale to an IGT or the gifting of discounted assets, the strategy should be utilized sooner rather later because if the Proposal's provisions are enacted "as is," the changes to grantor trusts would become effective upon the enactment of the legislation. All of the other factors that must be considered when gifting are still factors, such as the income tax implications of the loss of the step-up in basis and the loss of control and use of the asset.

In light of the potential increase in income tax rates for individuals starting in 2022, clients may believe that it would be better to accelerate any unrealized gains by selling an asset before January 1, 2022 in order to take advantage of lower capital gains rates. The problem with this approach is that, if the Proposal's changes with respect to capital gains becomes the law, it is already too late to take advantage of the lower capital gains rates because the capital gains provision affects gains recognized after September 13, 2021.

Additionally, if you have a significant IRA (i.e., over $10 million), and if both the IRA provisions and the ordinary income tax rate provisions are included as part of the legislation (i.e., raising the maximum rate from 37% to 39.6%), you will be required to take a significant required minimum distribution next year. Thus, you may wish to consider withdrawing the anticipated required minimum distribution in 2021 versus 2022 in order to pay taxes at the lower rates. You should speak with your investment advisor, as well as your tax advisor, before taking this step.

Be Thoughtful

Most importantly, any and all decisions must be made after thoughtful consideration and analysis of the options and risks. To reiterate again, this Client Alert summarizes a *proposal* that is currently *NOT THE LAW* and may never become the law. We will keep you informed as significant changes occur.

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If you have any questions, please consult with one of our lawyers.

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