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Estate Tax Watch 2021: House Ways and Means Committee Proposal Lowers Estate Tax Exemption

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On Sunday, September 12th, the House Ways and Means Committee released a draft bill that would drastically alter the transfer tax regime and common estate planning strategies. The draft bill is only a proposal at this time. However, it does indicate Congressional action towards increasing the reach of the estate tax and severely limiting certain wealth transfer techniques.

This Alert focuses on the changes that directly impact common estate planning strategies. Those changes include:

1. Reducing the estate and gift tax exemption to $6,020,000, effective January 1, 2022.
2. Subjecting grantor trusts to estate tax.
3. Severely limiting the effectiveness of GRATs, QPRTs, SLATs and insurance trusts.
4. Eliminating valuation discounts in gifting passive, non-business-related assets.

As proposed, the changes to the taxation of grantor trusts and the loss of valuation discounts may be effective upon the law passing. Accordingly, if you are considering making a gift in 2021 to take advantage of the current gift tax exemption, then it would make sense to act quickly.

The balance of this Alert dives into more detail surrounding the proposed changes.

Changes to Exemption Amounts

Currently, each individual can transfer up to $11,700,000 without incurring a federal gift, estate or generation-skipping transfer ("GST") tax. This exemption amount was set by the Tax Cuts and Jobs Act of 2017 and has been adjusted annually by inflation to reach the current level. The draft bill would reduce each exemption amount to $6,020,000, effective January 1, 2022.

This reduction is important for any client considering using up their gift tax exemption. Before December 31, 2021, a client without prior gifting can transfer $11,700,000 without incurring a federal transfer tax (and a married couple that agrees to "split" the gift can transfer $23,400,000). If the draft bill passes, then the same client would be capped at $6,020,000 (or $12,040,000 for a married couple). Essentially, it is a missed opportunity to gift $5,680,000 of assets without incurring a gift or GST tax ($11,360,000 for a married couple).

A similar reduction to the exemption amounts was scheduled to occur after December 31, 2025, per the terms of the Tax Cuts and Jobs Act of 2017. This proposal makes that change happen at the end of this year instead.

Changes to Grantor Trust Taxation

A "grantor trust" is a trust that is disregarded for federal (and sometimes state) income tax purposes, meaning that the "grantor" (or creator) of the trust pays all income tax on behalf of the trust. Yet, trust assets are not "included" in the grantor's estate for federal estate tax purposes, meaning that the trust is not subject to federal estate tax on the grantor's death. This type of trust allows assets to appreciate income tax free for the beneficiaries. It also permits the grantor to engage in several estate planning transactions with the trust, such as sales and loans to the trust, without incurring federal income tax. Most irrevocable dynasty trusts, including spousal lifetime access trusts ("SLATs"), are grantor trusts.

The draft bill adds new sections to the Internal Revenue Code that would fundamentally change the use of grantor trusts in three important ways:

- First, a grantor trust would be included in the "deemed owner's" taxable estate, with a credit adjustment to account for the use of gift tax exemption when the gift was made. Effectively, the appreciation on the gift is included in the grantor's estate.

- Second, gift tax would be triggered on any distribution from a grantor trust to a trust beneficiary. There are two limited exceptions: (1) if the recipient beneficiary is the grantor's spouse, or (2) if the distribution discharges an obligation of the grantor, such as a distribution to a minor child of the grantor.

- Lastly, asset sales to the grantor trust by the deemed owner would incur federal income tax in the same manner as if the deemed owner sold assets to a third party. This precludes a grantor from selling appreciated assets to her grantor trust because the sale would be treated as a realization event with the grantor recognizing taxable gain. In addition, this section of the draft bill adds "grantor trust" and "deemed owner" to the category of "related parties" for whom losses are disallowed in sales or exchanges between the two related parties.

The effective date of these changes to grantor trust taxation is the date of the bill's enactment, and its application would be to any grantor trust created on or after that date, as well as to any contribution to an existing trust on or after that date. This proposal seems to not apply to existing grantor trusts to which no additional contributions are made.

After enactment, the following estate planning opportunities become either less desirable or even unavailable: (a) funding grantor retained annuity trusts ("GRATs") or qualified personal residence trusts ("QPRTs"), (b) funding spousal lifetime access trusts ("SLATs") and (c) funding irrevocable life insurance trusts ("ILITs").

The purpose of GRATs and QPRTs is to transfer asset appreciation to the next generation with little to no gift tax. If the tax bill is passed, GRATs and QPRTs become undesirable because, upon expiration of the GRAT or QPRT term, at which time trust assets transfer to the remainder beneficiaries (i.e., the next generation), there would now be a deemed gift subject to gift tax on the amount being transferred. This new deemed gift could generate a huge tax bill if the planning was successful and the assets appreciated as planned.

SLATs are attractive trusts for many clients because they allow the grantor to make completed gifts that are outside of her estate while maintaining access to the funds transferred if needed via distributions to her spouse, as a trust beneficiary. Unfortunately, trusts whose income can be distributed to, or accumulated for the benefit of, a grantor's spouse generally qualify as grantor trusts.

ILITs are frequently used by clients to remove the proceeds of their life insurance policies from their taxable estates. Similar to SLATs, by their nature, ILITs will be grantor trusts because a grantor trust includes trusts where the income can be applied for the payment of premiums on policies of insurance on the life of the grantor (or the grantor's spouse). For those clients with existing ILITs, this is especially problematic because future, annual contributions to the trust to pay premiums will cause the ILIT to be subject to the provisions of the draft bill since additional contributions are made after enactment. For clients who are able to, we recommend prefunding your insurance trusts now to cover future annual premiums.

Valuation of Passive Assets That Are Gifted

The draft bill targets another common estate planning tool by eliminating valuation discounts in connection with lifetime gifting. Clients who own interests in hedge funds, private equity funds, family partnerships or LLCs often wish to gift a portion of their interests to a trust for their descendants. These gifts have typically been able to benefit from significant discounts for lack of control and lack of marketability. These discounts arise because a third-party willing buyer would pay less for a minority interest in an entity where the buyer lacks control and holds only a minority position.

The draft bill removes any valuation discount for entities that hold passive assets such as an investment portfolio. The bill defines passive assets as assets that are held for the production of income and not used in the active conduct of a trade or business. The draft bill contains a list of passive assets which includes cash or cash equivalents, stock in a corporation or any other equity, profits or capital interest in a partnership, evidence of indebtedness, options, forwards or futures contracts, annuities, real property (i.e., a residence), personal property and collectibles (i.e., art).

Income Tax Rate Increases and Surcharges

The proposed changes to income tax rates would affect not only individual taxpayers, but also estates and trusts. Under the draft bill, the top marginal individual income tax rate increases from 37% to 39.6% and broadens the group of taxpayers who are in the top bracket by applying it to (a) married taxpayers filing jointly with taxable income over $450,000, (b) married taxpayers filing separately with taxable income over $225,000, (c) heads of households with taxable income over $425,000, (d) single taxpayers with taxable income over $400,000 and (e) estates and trusts with taxable income over $12,500. The draft bill also applies a 3% surcharge tax to trusts or estates with income exceeding $100,000, to married taxpayers filing separately with income exceeding $2,500,000 and to any other taxpayer, such as married taxpayers filing jointly and heads of households, with income exceeding $5,000,000.

The effective date of these tax rates and the tax bracket is January 1, 2022.

However, the change to the top capital gains rate, which is increased to 25%, is effective beginning after September 13, 2021.

What Do You Do Now?

It is time to act on your estate planning. Prior to the enactment date of the draft bill, SLATs, GRATs, QPRTs and other grantor trusts are available for estate planning with all of the benefits as we have known them. In addition, if you have existing trusts and are considering making changes to their terms through a decanting, now is the time to do it, because it is possible that a decanting to a new trust under this proposed law would be treated as a distribution that is now a deemed gift subject to gift tax.

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