

## Practice Update

# Draft Legislation in U.S. House of Representatives Would Dramatically Alter Estate Planning Strategies

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On September 10, 2021, the U.S. House Committee on Ways and Means released a draft of proposed legislation that, if enacted into law, would reduce the estate tax exemption and significantly limit the effectiveness of certain estate planning strategies. The draft legislation incorporates various proposals advanced by several members of Congress earlier this year and may serve as further evidence that taxes on the wealthy likely will increase. We summarize various proposed changes that may impact year-end estate planning.

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## I. Decrease in the Exemption Amounts

**Current Law:** As you may recall, under the Tax Cuts and Jobs Act of 2017, the basic estate, gift, and generation-skipping transfer (GST) tax exemption doubled from \$5 million per individual, indexed for inflation, to \$10 million per individual, indexed for inflation, beginning January 1, 2018 and ending December 31, 2025. In 2026, the exemption amount would revert to \$5 million per individual, indexed for inflation.

**Proposed Law:** The House proposal accelerates the reversion of the exemption amount to \$5,000,000 per individual, indexed for inflation, beginning on

January 1, 2022 (estimated to be \$6.02 million in 2022). Accordingly, if not used by December 31, 2021, an individual may lose the benefit of approximately \$5.680 million [1] (or \$11.36 million per married couple) of the estate, gift, and GST tax exemption. Therefore, consideration should be given to making gifts in 2021 to utilize the “excess exemption amount.”

## II. Changes Applicable to Grantor Trusts

The proposals discussed under this section will apply to: (1) trusts created on or after the date of the enactment of the law, and (2) any portion of a trust established before the date of the enactment of the law which is attributable to a contribution made on or after such date.

### A. Deemed Owner of Grantor Trust

**Current Law:** A trust is considered a “grantor trust” for income tax purposes if the grantor retained certain powers or entitlement under the trust agreement. If the trust qualifies as a grantor trust for income tax purposes, the grantor is the “deemed owner” and is taxed on the income of the trust (*i.e.*, the grantor reports the income on his or her Form 1040). The grantor’s payment of the income tax liability is not considered an additional gift by the grantor to the trust. Accordingly, an irrevocable “gift trust” drafted to be a “grantor trust” may grow, unreduced by the payment of the income tax; and, thereby, additional wealth is transferred to the beneficiaries of the trust.

Even though the trust is disregarded for income tax purposes, it is not disregarded for federal estate tax purposes – meaning, if the trust is properly drafted, the assets of the trust are not included in the grantor’s taxable estate. This dichotomy allows the grantor trust to serve as the central component of significant estate planning structures (*i.e.*, spousal lifetime access trusts or SLAT’s; gift/sale transactions, grantor retained annuity trusts or

GRAT's; and irrevocable life insurance trusts or ILIT's).

**Proposed Law:** Under the House proposal, a grantor's taxable estate will include any trust over which he or she is the "deemed owner." A credit will be applied at the grantor's death with respect to any gift tax exemption used on the original transfer into the trust; however, any appreciation of the trust after the transfer will not escape estate taxation as allowed under current law.

## B. Tax on Distribution

**Current Law:** Generally, a distribution to a beneficiary of an irrevocable grantor trust can be made gift tax free. For example, if the grantor made a completed gift to the grantor trust for the benefit of the grantor's descendants and applied all or a portion of the grantor's gift tax exemption to the transfer, then any distribution from the trust to a beneficiary thereof is not subject to the gift tax.

**Proposed Law:** Under the House proposal, any distribution (other than to the deemed owner or the deemed owner's spouse) from the grantor trust to one or more beneficiaries during the life of the deemed owner (other than in discharge of an obligation of the deemed owner) shall be treated as a transfer by gift.

## C. Sale to Grantor Trust

**Current Law:** A sale between a grantor and his or her "grantor trust" is disregarded for income tax purposes even though the sale is recognized for all other purposes. Therefore, capital gain is not recognized on any sale transaction between the grantor and the grantor trust (*i.e.*, the grantor is the only taxpayer involved in the transaction). Estate planners have capitalized on this aspect of the law in structuring sale techniques involving grantor trusts. Generally, for estate tax purposes, the value of the asset sold is "frozen" at the time of the transaction

(i.e., the grantor receives consideration for an asset at its fair market value at the time of the sale), and the appreciation on the asset after the sale passes to the grantor trust free of estate tax as summarized above. The combination of the “freeze” and the grantor paying the income tax (as discussed above) on the assets of the grantor trust result in significant wealth being shifted from the grantor to the grantor trust.

***Proposed Law:*** Under the House proposal, a sale between grantor trust and the “deemed owner” of the grantor trust is equivalent to a sale between the grantor and a third party. Therefore, the grantor must recognize capital gain on the sale.

### **III. Changes to Valuation Discounts**

***Current Law:*** Generally, valuation discounts (i.e., for lack of marketability and control) are available when a minority interest in a closely-held business is transferred via gift or sale. For instance, a taxpayer may gift a non-voting interest in a limited liability company or limited partnership to a trust created for his or her descendants at a discounted value. The ability to utilize discounts result in the leverage of the gift tax exemption so that a taxpayer can transfer additional wealth. For example, consider that a taxpayer would like to transfer by gift a non-voting minority interest in a company valued at \$10 million. Under current law, discounts may apply as follows:

	<u><b>Current Law</b></u>
Gross Value:	\$10 million
Discount (lack of marketability):	(\$2 million)
Discount (lack of control):	(\$1 million)
Net value for gift tax purposes:	\$7 million

Accordingly, by the application of the discounts, the taxpayer is able to transfer \$10 million of wealth by utilizing only \$7 million of his or her gift tax exemption. The taxpayer is able to apply the “savings” of \$3 million to other transfers.

***Proposed Law:*** Under the House proposal, the transfer of nonbusiness assets would not be afforded a valuation discount for transfer tax purposes. Generally, passive assets that are held for the production of income and not used in the active conduct of a trade or business are considered nonbusiness assets. Common examples of passive assets include cash or cash equivalents; stock in a corporation or any other equity; profits or capital interest in an entity; evidence of indebtedness; annuities; trademarks or copyrights which produce royalty income; commodities; collectibles or personal property.

If the proposal becomes law and the company in the example above was not actively engaged in a trade or business, then the taxpayer cannot obtain the \$3 million of savings and instead must make the gift at an undiscounted value of \$10 million. The new law would become effective when the legislation is enacted.

#### IV. Surcharge on High Income Individuals, Estates, and Trusts

***Current Law:*** Irrevocable trusts that are not grantor trusts or simple trusts are taxed at compressed income tax brackets on undistributed income. For instance, under the 2021 tax brackets, a trust with income exceeding \$12,950 is taxed at the 37 percent rate; whereas, an single individual is taxed at the 37 percent tax bracket if he or she has income of \$523,601 or more.

***Proposed Law:*** Under the proposal, the highest individual income tax rate increases from 37 percent to 39.6 percent. Further, a non-grantor, complex trust will reach the highest rate of tax if it has taxable

income over \$12,500. In addition, estates or trusts with income over \$100,000 must pay an additional 3 percent tax on their “modified adjusted gross income” which is defined as adjusted gross income reduced by any deduction (not taken into account in determining adjusted gross income) allowed for investment interest. If enacted, the law would become effective beginning after December 31, 2021.

## Summary

Congress may pass tax legislation that includes all of the above, some combination of the above, or none of the above. Although we cannot definitively predict what will become of these proposals, we are implementing strategies to take advantage of current law. Most planning options may only be available if effectuated before December 31, 2021. Accordingly, doing nothing may be harmful to you. Please contact Stacey Prince-Troutman or any member of the Akerman Trusts and Estates Practice to discuss options currently available to you.

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[1] \$11.7 million (current exemption amount) *less*  
\$6.02 million (estimated exemption amount)

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