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Let the Estate Tax Planning Games Begin - But Where Will They Land - the House Ways and Committee Has Spoken

Steve Leimberg's Estate Planning Newsletter on **September 15, 2021**

"President Biden and Democrats in the Congress have been working on a $3.5 trillion spending and tax package, and the details are starting to be revealed. Indeed, on Sunday, September 12th, the House Ways and Means Committee released its proposal that would increase taxes on the wealthy.

Earlier in the year, there were proposals that would have dramatically changed the estate planning landscape (the 'For the 99.5% Act' and the 'STEP Act'). While many of the provisions in such proposals are not part of the most recent proposal, the ones that are included will affect how estate planners advise their clients. The good news is that the repeal of the step-up in basis rule and treatment of death as an income tax recognition event were not included. The bad news is that discount planning for nonbusiness assets and grantor trust planning would be gone.

Of course, this proposal is just the starting point, and probably represents a worst case scenario. However, planners should begin to focus on the proposed changes, as some of them, perhaps in proposed form or with modification, will make it through.

This newsletter discusses the provisions of the proposal that would affect estate planning as we know it today. The authors also share some planning opportunities that advisors to the wealthy should consider now, and in the future."

Andy Katzenstein and **David Pratt** provide members with commentary that examines the estate planning provisions in the Ways and Means Committee proposal.

Here is their commentary:

ESTATE, GIFT, GST AND GRANTOR TRUST PROVISION

Termination of Temporary Increase in Unified Credit (Bill Section 138207)

Section 2010(c)(3) of the Code is amended by eliminating subparagraph (C), which essentially reduces the Basic Exclusion Amount (a/k/a the Unified Credit) back to $5 million, adjusted for inflation since 2011. In addition, because Section 2631(c) of the Code ties the GST tax exemption to the amount of the basic exclusion amount, the GST tax exemption will also return to $5 million, indexed for inflation since 2011. In 2022, the Basic Exclusion Amount (and the GST tax exemption) will be $6,020,000. *Effective date: for gifts made and decedents dying after December 31, 2021.*

Comment: This change was scheduled to occur for gifts made or decedents dying after December 31, 2025. The effect of this provision is to accelerate that change. Importantly, there was no "disconnect" between the amount of unified credit that could be used for gifts as opposed to estates, portability continues to apply and the inflation adjustment was retained.

Increase in Limitation on Estate Tax Valuation Reduction for Certain Real Property Used in Farming or Other Trades or Businesses (Bill Section 138208)

Section 2032A(a)(2) of the Code is amended to benefit taxpayers who own farms. Typically, for estate tax purposes, real property is required to be valued at its highest and best use. Farmland often is not the highest and best use of property; therefore, families who owned farms might have to pay estate tax on the farmland at a much higher amount. Existing law allows for a valuation adjustment downwards of up to $750,000 to provide relief from this consequence. The new law would allow a reduction in value for farmland of up to $11,700,000 from what otherwise would be the value of the land determined at its highest and best use. *Effective date: estates of decedents dying after December 31, 2021.*

Comment: The entire bill includes provisions to help family farmers. This is the only taxpayer helpful provision of the proposed new law.

Certain Tax Rules Applicable to Grantor Trusts – Estate Tax Inclusion (Bill Section 138209)

A new Section 2901 is added to the Code. This section includes in a decedent's taxable estate any portion of a grantor trust's assets of which the person is the "deemed owner" and, generally, treats a distribution made from a grantor trust as a gift, unless (a) the distribution is made to a grantor's spouse, or (b) the distribution discharges an obligation of the deemed owner. If the trust's grantor status is terminated during the grantor's lifetime, the assets will be treated as being gifted at that time by the grantor. A "proper adjustment" will be made if assets of a grantor trust are included in the grantor's taxable estate to account for amounts previously treated as taxable gifts by the grantor to the trust. *Effective date: trusts created on or after the date of enactment (or to any portion of a trust that was created before the date of enactment which is attributable to a contribution made on or after the date of enactment).*

Comment: This rule comes from the proposal in the For the 99.5% Act. It generally discourages establishing grantor trusts to permit the grantor to continue to pay income tax on the trust income without that payment being treated as a gift for gift tax purposes from the grantor to the trust (a "non-gift gift"). By including the assets of the grantor trust in the grantor's taxable estate, grantors no longer have the incentive to seek to make these "non-gift gifts"; moreover, spousal lifetime access trust ("SLAT") planning will also no longer be as valuable because, in general, a SLAT is a grantor trust and a gift of assets to a SLAT will no longer avoid inclusion in the grantor's taxable estate. By its terms, this provision would also seem to eliminate the tax benefits of GRATs and QPRTs created after the date of enactment because when the term interest of the grantor in the GRAT or QPRT terminates, there will be distribution from the grantor trust and a deemed gift will occur, or because when the term interest terminates, the GRAT or QPRT will no longer be a grantor trust – again, a deemed gift would then occur. Perhaps this is an unintended consequence, as one would think that if Congress wanted to eliminate the tax planning benefits of GRATs or QPRTs, those provisions of the Code would just be eliminated. Nevertheless, until there is further clarification, prudence might suggest not creating GRATs or QPRTs after the date of enactment.

There is also a hidden issue with respect to qualified subchapter S trusts (a "QSST") that arises if this provision becomes law. The "deemed owner" is defined to be "any person who is treated as the owner of a portion of a trust under Subpart E of part 1 of subchapter J of chapter 1" of the Code. A QSST is a "beneficiary deemed owner trust," as Section 1361(d)(1)(B) of the Code states that for purposes of Section 678(a), the beneficiary is the deemed owner of the trust. Query whether the QSST is a grantor trust under Subpart E (because of the reference in Section 1361(d)(1)(B) to Section 678(a)) or whether it is a grantor trust because of the rule in Section 1361(d)(1)(B) – which is in Subchapter S of the Code. Though the answer is certainly not clear, it would seem to be the intended result for a parent to establish a QSST for a child and that when the child dies, that trust is included as part of the child's taxable estate. Until this issue is clarified by regulations, perhaps holding S stock in an ESBT may be the safest alternative, despite the applicability of the highest income tax rate that is applied to an ESBT.

Most life insurance trusts are grantor trusts under Section 677(a)(3) because trust income can be used to pay insurance premiums. While it is believed that the IRS takes the position that such a trust is a grantor trust if the income is actually used to pay premiums, a literal reading of the Code does not seem to require the income to be used to afford grantor trust treatment. If grantor trusts are now included in the grantor's taxable estate, new ILITs would likely need to prohibit payment of premiums from trust income (directing that such payments only be made from trust principal). This rule may be very problematic and could turn the insurance industry upside down, as all or a portion of most existing irrevocable life insurance trusts ("ILITs") that receive contributions after the effective date to pay premiums could cause all or a portion of existing ILITs to be included in taxpayer estates. Many expect the insurance lobby to try and carve out an exception from Section 2901 for ILITs for this reason. We'll need to wait to see if any such exception is part of a final bill that is enacted.

Certain Rules Applicable to Grantor Trusts – Gain Recognized on Sale (Bill Section 138209)

A new Section 1062 is added to the Code. This section provides that the grantor trust rules are ignored whenever there is a transfer of property between a trust and the deemed owner of the trust as part of a sale or exchange transaction. The rule specifically will not apply to the deemed owners' revocable living trust. A further amendment is made to the related taxpayer rules in Section 267(b) of the Code by adding a new subsection (14), which provides that a grantor trust and its deemed owner are "related parties." The effect of this change is to disallow any losses generated by the sale or exchange of an assets between a grantor trust and its deemed owner. *Effective date: sales to trusts created on or after the date of enactment (or to any portion of a trust that was created before the date of enactment which is attributable to a contribution made on or after the date of enactment).*

Comment: This provision may eliminates the benefit of the "sale to defective trust" or "IDIT" planning technique if the IDIT is created after the date of enactment because gain will be recognized on the sale. Thus, if a taxpayer wants to remove potential appreciation on a particular asset, there will be a "cost" to do so – he or she will have to pay the immediate capital gain. Consequently, making sales to non-grantor trusts for this purpose as early in the life of the asset being sold will become even more important as, presumably, the gain will be minimal at that time. (Even better, if non-grantor trusts for children could initially invest in the entity at the time of creation, this gain issue can be avoided entirely.) Importantly, the rule only ignores the grantor trust rules where there is a sale or exchange. If trusts exist where, for example, a grantor has transferred his or her home to a grantor trust and is renting that home back, payment of rent to that trust should still continue on an income tax-free basis.

Apparently, based on a literal reading of the proposed law, sales occurring after the effective date made to IDITs that were created before the effective date will not be subject to capital gains tax under this new rule. Some are considering the creation of IDITs prior to the effective date and nominally funding them to keep the option open to make sales those trusts after the effective date without incurring capital gains tax. Of course, there is tax risk created when assets are sold to an otherwise empty trust for a note (i.e., the 10% "seed money" issue) that would need to be addressed (perhaps using beneficiary guarantees – but then would a guarantee fee need to be paid that has its own income tax consequence?), but if no pre-effective date IDIT is created, this opportunity would certainly be unavailable.

Valuation Rules for Certain Transfers of Nonbusiness Assets (Bill Section 138210)

Code Section 2031(d) would be replaced with a new 2031(d) (the current Section 2031(d) is renumbered 2031(f)). It applies to valuation of entity interests owned at death and also to entity interests transferred by gift (and would also apply to determine whether there is any gift element where there is a sale to a trust for children). The new rules apply to the transfer of "nonbusiness assets" that are held by an entity that is transferred after the date this proposal is enacted. In essence, the nonbusiness assets held by the entity are valued with "no valuation discount" and the nonbusiness assets would not be taken into account when valuing the entity.

Nonbusiness assets are defined as any passive asset which is held for the production or collection of income and is not used in the conduct of an active trade or business. Specifically listed passive assets include cash or cash equivalents, stocks in a corporation or any other equity, profits, or capital interest in an entity, evidences of indebtedness, annuities, real properties, assets other than a patent, trademark or copyright which produces royalty income, commodities, collectibles or personal property.

Passive assets which are held as part of the reasonably required working capital of a trade or business are excepted from the rule. Real property is another example of a passive asset that is excepted from this rule, but only if they are real property assets used in the active conduct of real property trade or businesses in which the transferor materially participates. A "real property trade or business" is one that involves development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business. The transferor must perform at least 750 hours of services during the taxable year in the real property trade or business in addition to "materially participating" (i.e., be involved in the operations on a regular, continuous and substantial basis) in that business. No interest in a limited partnership held as a limited partner is to be treated as one in which the taxpayer materially participates.

There is a “look-through” rule which says that the assets of an entity owned by a subsidiary entity that the parent holds 10% of (i.e., 10% of the vote or value of the entity) are treated as being directly owned by the parent entity – this seems to be in the law to allow holding company interests to receive discounts when transferred so long as the subsidiary assets are used in an active business. *Effective date: transfers after the date of enactment.*

Comment: This rule effectively eliminates discounts for entities other than their assets used in an active business. In other words, planners will no longer be able to contribute stocks and bonds to an entity and then apply a discount for the gift of an interest in that entity interest. In some ways this provision is broader than that proposed as part of the For the 99.5% Act – there, the limits would only apply if the transferor or his or her family controlled the entity before and after the transfer. That qualifier is not part of the proposal which is part of the House bill. Importantly, the rule only applies to entity interests – suggesting that if a partial interest in a piece of real property is transferred, discounts could still be applied.

INCOME TAX PROVISIONS AFFECTING ESTATES AND TRUSTS

Surcharge on High Income Estates and Trusts (and Individuals) (Bill Section 138206)

Section 1A is added to the Internal Revenue Code of 1986, as amended (the “Code”) and provides that estates or trusts with income over $100,000 pay an additional 3% tax on their “modified adjusted gross income,” defined as adjusted gross income (“AGI”) reduced by any deduction for investment interest not allowed in calculating AGI. For trusts and estates, AGI is determined as in Code Section 67(c). Charitable trusts (those where “all the unexpired interests are devoted to a purpose described in 170(c)” – so split interest trusts would not qualify for this exception) are not subject to these rules. *Effective date: tax years after 2021.*

Comment: Trusts are already taxed at the highest brackets at $13,050, contrasted with individuals who are taxed at the highest bracket when their income gets to $523,600 (for a single taxpayer). This surcharge makes accumulated income taxed to a trust even more disadvantageous – adding 3% to the income tax rate. Planners often suggest that trusts accumulate income so that amounts can remain in generation-skipping transfer ("GST") tax exempt trusts. Query whether that benefit would erode over time so that distributing income to save the surcharge annually (where the beneficiary is not subject to that surcharge rate) might, in some cases, outweigh the GST tax benefit. Another impact might be to reallocate the investments in those trusts more towards tax-free bond investments, or perhaps investments in assets that can be offset by depreciation.

QSBS Limitations Applicable to Trusts or Estates (Section 138150)

Under Section 1202, there are exclusions from gain for the sale of qualified small business stock ("QSBS")("QSBS Exclusion"), generally up to $10 million per taxpayer. This new provision would cap the gain that can be excluded for trusts and estates selling QSBS stock at 50%. *Effective date: sales after September 13, 2021, except for gain resulting from sales under contracts binding on September 12, 2021*.

Comment: Many taxpayers can avoid of 75% or even 100% of the capital gain on the sale of QSBS stock. A common planning technique has been to "stack" the exclusion by transferring QSBS prior to a sale of the stock to a non-grantor trust. As written, Section 1202 applies on a taxpayer by taxpayer basis; thus, an individual who gifts QSBS to a non-grantor trust could obtain two QSBS Exclusions, and there is nothing to prevent an individual from creating multiple non-grantor trusts to exploit the QSBS Exclusion to obtain one exclusion per trust. Under this new proposed provision, for trusts selling QSBS, the exclusion will be limited to 50% of the exclusion that would otherwise apply.

What Is Not Part of the Bill?

Many possible tax law changes that were rumored to be forthcoming are not part of this proposal. There is no deemed sale at death. There is no elimination of the basis step-up at death. There are no added limitations on GRATs. There is no mention of a "Federal" rule against perpetuities to eliminate dynasty trust planning. There is no increase in estate tax rates, or estate tax rate surcharges for billionaires.

What Should Individuals do Now, Before a Bill Passes?

Clients should focus on creating SLATs, undertaking sales to grantor trusts (using valuation discounts), and using their gift (i.e., unified credit) and GST tax exemptions before they lose them. For clients who have already exhausted their gift tax exemption, but not their GST tax exemption, it may make sense to make a gift equal to the balance of their GST tax exemption and pay gift tax on the gift – if the donor lives for three years from the date of the gift, the gift tax paid will be removed from the estate.

What Will Planning Look Like in the Future if this Bill Passes?

Focus will be on forming non-grantor trusts for the benefit of children to invest in new ventures alongside parents from the start. That way, there is no capital gain that will be incurred to transfer interests in the entity to trusts for the children, which would otherwise be incurred if the venture had to be sold to the trust later on.

Loans to non-grantor trusts for children of funds that will be invested at the trust level to out earn the applicable federal rate will be a priority. Income tax would need to be paid on the interest received by the parent lender; in some cases, the interest may be deductible by the trust.

Discount planning for passive assets like real estate (except where the transferor materially participates) would focus on transferring undivided interests in the real estate itself, rather than in an entity owning the real estate.

Grantor trusts created before the rules change would probably not be the proper place for grantors to make future gifts to. Assets in the grantor trusts before the rules changed are “grandfathered” – assets in those trusts would not be subject to estate tax when the grantor dies. Assets added by contribution after the rules change to a grantor trust would be subject to estate tax when the grantor dies. To avoid the “bookkeeping” required if assets are added to otherwise grantor trusts, the best approach would likely be to create a new, non-grantor trust to which gifts could be made.

If a grantor intends to buy assets back from an IDIT for cash in order to cause those low basis IDIT owned assets to be included in the grantor’s estate and subject to estate tax (and instead push full basis cash to the IDIT outside the grantor’s estate), so long as the buyback is from and IDIT that existed prior to the date of enactment of Section 2901, that approach should still be effective.

Decanting?

The $64,000 question is whether assets transferred from a grantor trust to another grantor trust after the effective date of the proposed law would be grandfathered. In other words, does the new "decantee" trust retain the tax attributes of the initial trust, or would the IRS apply the new rules to the new trust. There does not appear to be an answer and the conservative approach would be to finish all proposed decantings prior to any change in the law. Indeed, the authors believe that a new trust that received assets from a prior trust would fall under the new "anti-grantor trust" provisions.

CONCLUSION

The bottom line for estate planning professionals is that if these pieces of the legislation pass in current form or modified form, the planning landscape will change dramatically. Assuming that the change in the exemptions would have an effective date on January 1, 2022, and that the other changes in the law would be effective on the date of enactment, planners should be proactive with their clients to seize on the favorable exemptions and laws that are still available.

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