ROPES & GRAY

ALERT ▪ Private Client

October 4, 2021

Budget Reconciliation Bill Sets the Stage for Estate Planning Overhaul

Attorneys
Marc J. Bloostein
Cameron Casey
Kimberly E. Cohen
Brenda S. Diana
Jennifer S. Ewing
Martin Hall
Geoffrey M. Mason

The House budget reconciliation bill, H.R. 5376 (the "Bill"), proposes sweeping changes to tax rules that apply to individuals and trusts, with far-reaching implications for estate planning. If enacted, the Bill would, among other things:

- Cut in half the basic exclusion amount, reducing the estate, gift and GST tax exemptions from $11,700,000 to approximately $6,020,000 in 2022;
- End the estate planning benefits of irrevocable grantor trusts; and
- Eliminate estate and gift tax valuation discounts on interests in nonbusiness entities.

1. Decrease of the Basic Exclusion Amount

Perhaps the least surprising estate planning change introduced by the Bill is the reduction of the basic exclusion amount available for estate and gift tax purposes (which is also the measure of the GST exemption). This is the threshold amount below which individuals may make gifts during life and transfers at death without incurring tax. From 2011 to 2017, the basic exclusion amount was $5,000,000 adjusted annually for inflation. Under the Tax Cuts and Jobs Act of 2017, the base amount was temporarily doubled from $5,000,000 to $10,000,000 for the years 2018-2025. The Bill would return the base amount to $5,000,000 (or $6,020,000 after the inflation adjustment) in 2022 rather than 2026.

In anticipation of this change, individuals should consider making gifts to use the higher exclusion amount before it disappears. Note, though, that one must transfer in excess of $6,000,000 to make use of any of the disappearing exclusion amount. We covered the use of the disappearing exclusion amount in detail in our October 2020 Alert, which anticipated some of the changes discussed here.

2. Loss of Benefits of Irrevocable Grantor Trusts

Under current law, an irrevocable grantor trust is a trust that has received a completed gift from an individual (the "grantor") and is not includable in the grantor's estate for estate tax purposes. For income tax purposes, however, the trust property continues to be treated as owned by the grantor. Accordingly, a grantor may sell assets to an irrevocable grantor trust without realizing gain (or swap assets with the trust), and may pay income taxes on trust income without making a gift to the trust.

The Bill would add two new sections to the Internal Revenue Code that would undermine the use of irrevocable grantor trusts in estate planning:

- New § 2901 would negate the estate tax benefits of irrevocable grantor trusts in the following ways:
  - The value of the trust assets would be included in the grantor's estate for federal estate tax purposes.
  - Any trust distribution during the grantor's lifetime to anyone other than the grantor or the grantor's spouse would be treated as a gift by the grantor.
  - If grantor trust status ends during the grantor's lifetime, the trust assets will be treated as transferred by gift by the grantor.

- New § 1062 would treat any sale or exchange between the grantor and his or her irrevocable grantor trust as a taxable event for income tax purposes.

When do these changes apply?

Under the Bill, these two new rules would apply:

- To trusts created on or after the date of enactment (the date the Bill, having been passed by both houses, is signed into law); and

- To any portion of a trust established before the date of enactment "which is attributable to a contribution made on or after such date."

However, the Report of the Budget Committee that accompanies the Bill indicates that the income tax provision triggering gain realization on sales and exchanges between a grantor and his or her grantor trust is intended to apply to post-enactment sales and exchanges *regardless of when the trust was funded*. In a footnote, the Report states that a technical correction may be necessary to effectuate this intent.

What does this mean for new planning if the Bill is enacted?

If the Bill is enacted, there will be no estate planning benefit to creating a new irrevocable grantor trust because such a trust would be subject to estate tax at the grantor's death (or subject to gift tax sooner in the event of a distribution or termination of grantor trust status). This will have an impact on several common estate planning trust arrangements that utilize grantor trusts, including:

- GRATs;

- Qualified Personal Residence Trusts (QPRTs);

- Irrevocable Life Insurance Trusts;

- Spousal Lifetime Access Trusts (SLATs);

- Certain Grantor Charitable Lead Trusts (CLTs); and

- Dynasty Trusts.

What does this mean for existing irrevocable grantor trusts?

The impact of the Bill on existing trusts is unclear. Although it is clear that the new rules would apply to an existing trust that receives post-enactment contributions, there is no guidance on the meaning of the term "contributions" and whether it will include transfers (and deemed transfers) other than actual gifts to the trust. The impact of the Bill is unclear even for existing trusts that do not receive post-enactment contributions, because existing trusts would be subject to the new rules regarding sales and exchanges if the proposed statutory language is revised as suggested in the Budget Committee Report.

What should be done today?

Before enactment, it is still possible to create new irrevocable grantor trusts or add to existing trusts. However, if the new arrangement will require future exchanges between the trust and its grantor (as with a GRAT), the risk that such exchanges will be taxable should be taken into account. Similarly, if the arrangement will require additional contributions (as with an irrevocable life insurance trust), the tax consequences of such contributions should be taken into account as well.

Also, existing trust arrangements should be reviewed to determine whether any transactions should be accelerated or unwound in light of the possibility that exchanges between a grantor and his or her grantor trust will be taxable. For example, if a grantor trust owes its grantor a substantial sum that ultimately is to be repaid with appreciated stock, it is worth considering whether the repayment should be made before the Bill is enacted.

3. End of Gift and Estate Tax Discounts on Interests in Entities Holding Nonbusiness Assets

Transferring interests in entities like family limited partnerships and LLCs to family members has been an effective estate planning strategy to move wealth to future generations while keeping the underlying investments pooled together. A significant advantage of this strategy lies in the discounts that can apply in calculating the value of the transferred interests for gift tax purposes, to account for factors such as lack of marketability and lack of control. Also, fractional interests in such entities held in a decedent's estate are also discounted in determining the value of the estate subject to estate tax.

The Bill introduces new § 2031(d), which aims to eliminate these discounts to the extent an entity owns nonbusiness assets. The Bill would require that an interest in an entity must be valued for gift and estate tax purposes without regard to any restrictions imposed by the entity itself.

Nonbusiness assets are defined broadly to include (i) any passive asset (ii) held for the production of income and (iii) not used in the active conduct of a trade or business. In most cases, this will include cash; real estate; financial investment assets, such as stocks, bonds and derivatives; as well as economic interests, such as profits interests (including carried interests) and capital interests in partnerships and similar vehicles.

Under the Bill, the elimination of these valuation discounts would apply to any transfer made or the estate of a decedent dying after the date of the enactment. This means that those who are planning to transfer discounted interests in family LLCs, real estate holding companies or similar investment vehicles should consider accelerating their timeline.

4. Other noteworthy changes

The Bill includes several other changes that, if enacted, could affect existing estate plans. Noteworthy changes include:

- The introduction of a 3% additional tax on high income individuals (>$5 million if married filing jointly) and trusts and estates (with income above $100,000);
- The increase of the top marginal income tax rate from 37% to 39.6%;
- The increase of the top tax rate for long-term capital gains and qualified dividends from 20% to 25%;
- The inclusion of active income from partnerships, LLCs and S corporations in categories of income subject to the 3.8% net investment income tax;
- A reduction of tax exemption on the sale of Qualified Small Business Stock from 100% to 50%; and
- Various changes to tax rules affecting retirement accounts (discussed in detail in a previous Alert), including mandatory distributions and contribution limits for large (>$10 million) retirement accounts, a prohibition on rollover to Roth IRAs and certain Roth conversions, and a prohibition on certain private investments by IRAs.