FRIED FRANK

To Our Clients and Friends

Memorandum

September 29, 2021

Last Chance to Use Many Effective Estate Planning Strategies

The House Ways and Means Committee released the text of sweeping changes to the estate, gift and income tax provisions of the Internal Revenue Code. We do not know whether this proposal (the "Chairman's Proposal") will be enacted, or how its provisions will change before enactment. If it is enacted, there will be a very limited window in which to take advantage of a number of popular and effective estate planning strategies.

This memo will highlight the major changes to the estate and gift tax provisions in the Chairman's Proposal. The major takeaway is this: if you have been contemplating making any major gifts, or using your lifetime gift tax exemption, you should not delay. Call us right away.

Estate, gift and generation-skipping transfer tax exemptions will be halved. The Tax Cuts and Jobs Act of 2017 ("TCJA") doubled the estate, gift and generation-skipping transfer tax exemptions to $10,000,000 per person adjusted for inflation; these exemptions are currently $11,700,000. TCJA provided that the increased exemptions would expire on December 31, 2025. The Chairman's Proposal accelerates the expiration to December 31, 2021. After that, the exemptions will return to their pre-2017 level of $5,000,000 adjusted for inflation, which would be approximately $6,020,000 in 2022. *If you do not fully utilize the gift and generation-skipping tax exemptions by the end of this year, you will lose the increased exemption amounts. The foregone tax savings would be about $2.3 million of Federal estate tax (plus applicable state estate tax).*

Estate and gift taxation of grantor trusts would change radically, eliminating their utility as estate planning vehicles. Many estate planning strategies use gifts to "grantor" trusts. Under current law, the grantor pays the income and capital gains taxes attributable to the trust, but that payment is not considered a taxable gift. The trust is not subject to estate tax in the grantor's estate. In addition, transactions between the grantor and the grantor trust are disregarded, allowing for asset sales and loans on advantageous terms. Many of the most common trusts used in estate planning – grantor retained annuity trusts (GRATs), insurance trusts, qualified personal residence trusts (QPRTs), trusts in which the grantor's spouse is either a beneficiary or trustee (including so-called SLATs) – are grantor trusts.

The Chairman's Proposal would change all of this for grantor trusts created *after the date of enactment* of the bill, and for contributions to existing grantor trusts made *after the date of enactment* of the bill. New grantor trusts would be subject to estate tax in the grantor's estate. Distributions from new grantor trusts would generally be treated as taxable gifts made by the grantor. If a new grantor trust ceased to be a grantor trust during the grantor's lifetime, that would be treated as a gift by the grantor of the entire value of the trust.

The provision that says that new contributions to an existing grantor trust would be subject to the new rules (e.g., making part of the trust subject to estate taxation in the grantor's estate) is particularly troublesome. A literal reading of the text would mean that, if the grantor of an existing insurance trust made post-enactment gifts to pay insurance premiums, part of the trust would be subject to tax in the grantor's estate (potentially including insurance proceeds). If an existing grantor trust was decanted to a new trust to modify administrative provisions, would the decanted trust be considered a post-enactment trust, even though no additional gifts were made to it? If an existing grantor trust provided that it would be divided at a future date into separate trusts for each of the grantor's children, would those separate trusts be considered post-enactment trusts? If so, un-grantoring those trusts after enactment would be considered a gift by the grantor, while the trusts or part of them might themselves be included in the grantor's estate. In addition, fair market value exchanges of appreciated property between a grantor trust and the grantor (currently used for a variety of estate planning purposes) would now trigger capital gains on the swap as to new grantor trusts (and just yesterday, the House Budget Committee released a report that said this change is intended to be extended to existing grantor trusts under circumstances that are not yet clear). These are only a few of the problems inherent in the Chairman's Proposal.

If you have been considering funding or adding to a grantor trust, you should do so as soon as possible. We do not know when a bill incorporating the grantor trust provisions will be enacted; at this writing, it is possible that if the Democrats decide that they must fold the debt ceiling increase into the reconciliation bill, enactment could happen very quickly.

Valuation discounts would be disallowed for non-business assets held in partnerships and other entities. Under current law, gifts of minority interests in closely held companies are valued with discounts for lack of marketability and lack of control. The Chairman's Proposal would eliminate these discounts for entities that hold passive investment assets.

Like the changes to the grantor trust rules, this provision would be effective for all transfers made after the date of enactment.

The Chairman's Proposal changes many income tax provisions applicable to high-income taxpayers. We are not going to summarize these, but if any of the items below is relevant to you, you should consult your tax adviser:

- The top personal income tax bracket will increase to 39.6%.
- The capital gains tax rate would increase to 25%, *effective for most transactions after September 13, 2021.*
- The 3.8% net investment income tax would also apply to income from a trade or business for high-income taxpayers.
- There will be a 3% surtax on all income, including capital gains, for modified adjusted gross income exceeding certain thresholds (e.g., $5,000,000 for individuals, heads of household or married taxpayers filing jointly, and a mere $100,000 for trusts and estates).
- There will be restrictions on Roth IRA conversions for high-income taxpayers.
- There will be restrictions on contributions to regular IRAs for high-income taxpayers with IRA balances of $10,000,000 or more; the same taxpayers will be required to make substantial withdrawals from their IRAs.

- There are some changes to the taxation of carried interests.

What's not in the Chairman's Proposal. Under current law, an individual's tax basis in property owned at death is "stepped up" to fair market value, often affording considerable capital gains tax savings. Previous statements and plans released by the Biden administration had led many observers to expect this basis "step up" to be targeted by tax reform legislation, but the Chairman's Proposal does not address the issue. Among other tax issues of relevance to our clients, the Chairman's Proposal does not address the deduction for state and local taxes (SALT), and does not change the rules applicable to tax-free exchanges under Section 1031. We understand that there are continuing discussions about these (and other) topics, and they may be addressed as the legislative process continues.

Conclusion. Do not delay if you are considering making major gifts this year. Please remember that this legislation may move quickly. This memo is a 30,000-foot view of the current landscape. If you have questions about specific provisions or topics, please contact us.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its contents. If you have any questions about the contents of this memorandum, please call your regular Fried Frank contact or an attorney listed below:

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