THE NAUTILUS GROUP®

Eye on Washington

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Ambitious legislative agenda including potential for major tax reform begins to take shape.

The 2020 elections ushered in a notable shift in political power in Washington, DC. With unified control of the White House and Congress (albeit by a very slim majority), the Democratic party is poised to act on an ambitious legislative agenda. Their first act, a $1.9 trillion wide-ranging COVID relief spending package known as the American Rescue Plan Act (ARPA), was signed into law on March 11, 2021. New spending and tax proposals are now being introduced that could have far reaching impacts for individuals and businesses. Notably, wealth transfer planning may be affected by what could be the most significant changes to the estate and gift tax rules in a generation. It is difficult to predict which proposals may eventually become law, but the likelihood of major tax rule changes seems very high, nonetheless.

Current plans and proposals

Biden Administration Infrastructure Plan

The Biden Administration recently announced a $2.3 trillion infrastructure plan that would be paid for largely by an increase in the corporate tax rate to 28%. The proposed plan reverses a sizable portion of the reduction of the corporate tax rate under the Tax Cuts and Jobs Act of 2017 (TCJA) from 35% to 21%. Additionally, corporations would be exposed to a minimum tax rate on foreign earnings at 21% (up from the 10.5% minimum established under the TCJA), and a 15% minimum tax on the "financial statement income" of large corporations. Changes in the corporate tax structure will likely meet significant resistance, and other options to finance the bill, through gasoline and/or mileage taxes as well as deficit financing, may be considered as well.

Sanders Estate Tax Bill

Senator Bernie Sanders (I-VT) and several co-sponsors introduced the "For the 99.5% Act" (the Act) in the Senate on March 25, 2021, aimed at a significant overhaul of the federal estate and gift tax laws. Key provisions include:

- Reduction of the current estate tax exemption level of $10 million adjusted for inflation (currently $11.7 million per person) to **$3.5 million per person** (with no inflation adjustment).
- Reduction of the gift tax exemption from the current ($11.7 million) estate tax exemption amount to **$1 million per person** (with no inflation adjustment).
- Increase in the applicable gift and estate tax rate from 40% to a graduated rate of **45%** on taxable estates up to $10 million, **50%** on additional wealth up to $50 million, **55%** on additional wealth up to $1 billion, and **65%** on wealth in excess of $1 billion.

The following example demonstrates the potential increase in estate tax exposure under the new law, assuming a married couple with a combined net worth of $10 million appreciating annually at 5% with full exemptions available.

	2021	2026 (Sunset)	2031	2041
Net taxable estate	$10,000,000	$12,762,816	$16,288,946	$26,532,977
Current/Projected federal exemptions	$23,400,000	$13,040,000	$14,400,000	$17,560,000
Federal estate taxes	$ -	$ -	$755,579	$3,589,191
Effective total estate tax %	**0.0%**	**0.0%**	**4.6%**	**13.5%**
Proposed federal exemption	$7,000,000	$7,000,000	$7,000,000	$7,000,000
Federal estate taxes	$1,350,000	$2,593,267	$4,180,026	$9,116,489
Effective total estate tax %	**13.5%**	**20.3%**	**25.7%**	**34.4%**
Potential increase in taxes	**$1,350,000**	**$2,593,267**	**$3,424,447**	**$5,527,298**

Notably, the effective date of the new estate and gift exemptions and tax rates is January 1, 2022, providing a window of opportunity to plan before year end. Specifically, large lifetime gifts made in 2021 appear to avoid the risk of a large tax liability from a retroactive change. However, rules pertaining to certain strategies and trust arrangements as described below would become effective sooner if the law is enacted this year, as such provisions are effective on the *date of enactment* of the law, further shortening the planning window for those contemplating large lifetime gifts.

In addition to a change in the exemption and applicable rates, Sanders' bill targets many estate and wealth shifting planning strategies that have been widely employed for decades:

- **Valuation discounts** for lack of control and marketability for any assets that are not used in the active conduct of a trade or business will be disallowed for estate and gift tax valuation purposes. This proposal is obviously aimed at family investment entities such as limited liability companies (LLCs) and family limited partnerships (FLPs), but still impacts operating companies depending on which assets of the company are deemed to be "used" in the conduct of the business.
- **Grantor retained annuity trusts (GRATs)** will be required to have a minimum taxable gift value as well as a minimum duration, negating the bulk of gift tax planning advantages of such arrangements. Under the proposal, GRATs will be required to have a *minimum* gift tax value of the greater of $500,000 or 25% of the value of assets contributed. This will foreclose the opportunity to reduce or eliminate gift taxes in "zeroed out GRATs." Additionally, GRATs will be

required to have a minimum duration of 10 years, significantly curtailing the ability to reduce the risk of volatility and estate inclusion when employing short-term "rolling GRATs."

- Perhaps the most significant attack on wealth planning techniques involves the approach taken towards irrevocable **grantor trusts** (also known as intentionally defective irrevocable trusts [IDITs]). Such trusts have formed the bedrock of wealth planning arrangements in recent years from lifetime exclusion gifts, annual exclusion gifting, asset sales, family business preservation, and life insurance planning. Under the proposal, grantor trust assets will be included in the grantor's taxable estate and reduced only by the value of any gifts made to the trust. This new rule for estate inclusion will apply to trusts established after the date of enactment of the law, ***as well as to any "contributions" made to pre-existing grantor trusts.***

Grantor trust example #1: Assume a lifetime gift of $1 million is made to a post-Act grantor trust. If the assets of the trust appreciate to $2 million upon the grantor's death, $1 million of trust property will be included in the grantor's taxable estate.

Grantor trust example #2: A lifetime gift of $1 million is made to a post-Act grantor trust. The assets in the trust appreciate to $2 million, at which point the trustee makes a distribution to a beneficiary who is not the grantor. A taxable gift by the grantor occurs at such point, though the grantor appears to be able to offset the value of any gift by the previously reported initial gift.

  - While this change for grantor trusts severely limits the efficacy of newly established trusts, ***the impact on current trusts and planning arrangements may be dramatic as well***. For example, many irrevocable life insurance trusts (ILITs; established to keep life insurance proceeds outside of the insured's taxable estate) are intended to be or otherwise would be considered grantor trusts under the tax code. Furthermore, such trusts are frequently designed to be funded with regular annual gifts to fund premiums. Therefore, there is potential that ongoing annual gifts to fund premiums will result in a portion of the insurance proceeds being included in the grantor's estate. In most cases, the grantor and insured are the same individual.
    - The proposal to alter the estate tax treatment of grantor trusts dates back to the Obama Treasury department in 2016, however life insurance trusts were exempted from prior proposals. No such exception seems to be included in the recent legislation at this stage.

ILIT example #1: Pre-Act grantor trust ILIT funded with total premium gifts of $100K. Post-Act premium gifts total $100K until grantor's death. Death proceeds on policy assumed to be $500K. Death proceeds "attributable to a contribution made on or after enactment" would be includible in the taxable estate. It is not completely clear whether the full proceeds less total gifts of $300K ($500K less total gifts of $200K) would be includible in the taxable estate, or the pro-rata share of proceeds relative to the post-Act gifts ($100K/$200K x $300K = $150K).

ILIT example #2: Pre-Act grantor trust ILIT funded under **split dollar loan arrangement** with $100K loan for premiums. Post-Act loans total $100K until grantor's death. Death proceeds assumed to be $500K, with $200K plus interest payable to estate. Insurance proceeds should remain outside of grantor's taxable estate so long as no "contributions" made to the trust post Act.

- Grantor trusts also are frequently used to effect sales or loans in exchange for a note receivable. Because transactions between a grantor and his or her grantor trust are disregarded for income tax purposes, capital gains on sales are avoided, as well as taxation of interest income. Furthermore, the grantor remains liable for income taxes due on income earned by a grantor trust, while payment of such taxes does not constitute a gift to the trust.
    - For pre-existing grantor trusts, it appears that outstanding loans and additional loans to the trust would not automatically alter the current transfer tax treatment of such trusts. Note that inadvertent transfers to trusts in the form of direct or indirect gifts must be carefully avoided to preserve desired tax treatment.
- Other salient features of the grantor trust tax rule changes include the following:
    - To ensure satisfaction of the tax liability, the bill makes any grantor trust subject to estate tax responsible for such payment.
    - Termination of grantor trust status during the grantor's life triggers a taxable gift of any asset value that was not previously treated as a gift.
    - The assets of a "beneficiary defective trust" (BDT) are included in the deemed owner beneficiary's taxable estate to the extent such beneficiary engages in a sale, exchange, or comparable transaction with the trust.

- Perhaps as dramatic as the potential changes for grantor trusts involves a **limit on the effective duration of the generation skipping transfer (GST) tax exemption.** Under current law, the GST exemption mirrors the estate tax exemption, and can be applied to transfers to grandchildren and more remote descendants to avoid GST tax (a tax that otherwise applies to wealth transfers on a generational basis regardless of whether includible in one's taxable estate). Under the Act, allocation of GST exemption would be effective for no more than 50 years. To be eligible for GST allocation post enactment, a qualifying trust will be required to terminate within 50 years. For pre-existing GST exempt trusts, they will remain GST exempt for a period of 50 years from enactment. This provision places popular dynasty trust arrangements squarely within the crosshairs, requiring trusts to revert property to beneficiaries for estate inclusion regardless of the state rules governing permissible duration of trusts. Dynastic trust arrangements have increased in popularity in recent years for many non-tax reasons, including creditor and divorce protection, consolidated wealth management, and protection from mismanagement or overspending by an heir. Post enactment, however, it appears that newly established trusts will not be able to enjoy any benefits of the GST exemption in passing wealth to grandchildren and further descendants unless the trust specifically terminates after 50 years nonetheless.

GST example #1: Post enactment and upon a grandparent's passing, $3.5 million (the available estate and GST exemption) is left in trust for the collective benefit of children and grandchildren. The trust is intended to provide asset protection and wealth management, and therefore continues for the lives of the children and then in further trust for the benefit of grandchildren. Absent specific direction that the trust terminate within 50 years of its creation, it appears that any distributions to grandchildren will be subject to GST taxation (regardless of when made), and the entirety of the trust will be subject to GST tax upon the death of the last surviving child beneficiary.

GST example #2: A trust established for children and further descendants prior to enactment is fully GST exempt and has assets worth $10 million. The trust terms require that it continue for the lives of the beneficiaries as long as the rule against perpetuities permits. Fifty years from the date of enactment, the trust (if still in existence) will cease to be GST exempt. At that point, any distributions to grandchildren or further descendants will be subject to GST tax, and the entirety of the trust will presumably be subject to GST tax upon the death of the last surviving child (non-skip) beneficiary.

  - Note that considerable difficulty will arise if this provision is enacted in its current form, as it would dictate the duration of trust planning for tax purposes. Changes to irrevocable trusts (post gift or death of the grantor) may be difficult to make in response to subsequent changes in the estate and GST laws (e.g., assuming this provision is repealed or modified within the next 50 years, a not inconceivable prospect given the ever present dynamism in tax legislation).

- Lastly, the Act provides **a cap on the total annual exclusion gifts a donor is permitted to make in trust** to twice the annual exclusion amount ($30,000). Under current rules, donors' gifts in trust are eligible for the annual exclusion (currently $15,000) for each beneficiary on whom a right to withdraw such gift is conferred. This limitation will prove very problematic for existing gifting arrangements, especially irrevocable life insurance trusts, as the provision does not appear to offer any grandfathering for pre-existing trusts. As a result, ILIT funding arrangements carefully designed to fall within the annual exclusion could trigger gift taxes moving forward. The Act also provides a cap on the total annual exclusion gifts a donor is permitted to make of an interest in a passthrough entity (presumably partnership, LLC, or S corp interest) to twice the annual exclusion amount as well.
- The one arguably tax-payer friendly provision found in the bill entails an **increase in the Section 2032A special use valuation** for farmland limit from $750,000 to $3 million.

Again, while the new exemption levels will not become effective until January 1, 2022, the inclusion rules for grantor trusts begin on the date of *enactment* of the law (i.e., date it is signed into law). As a result, while excess exemption gifts may be made prior to the end of 2021, a gift in trust may not achieve the full benefit if made to a grantor trust. In most cases, large lifetime gifts are generally made in trust to provide enhanced creditor protection for the beneficiary and avoid inclusion in his or her own taxable estate where GST planning is employed, which itself is curtailed as described. Therefore, planning discussions around such gifting arrangements should not be delayed.

STEP Act

On March 29, 2021, Senators Chris Van Hollen (D-MD), Cory Booker (D-NJ), Bernie Sanders (I-VT), Sheldon Whitehouse (D-RI), and Elizabeth Warren (D-MA) introduced a discussion draft of the Sensible Taxation and Equity Promotion (STEP) Act. Following up on the Biden campaign proposal, the STEP Act would tax unrealized capital gains of assets transferred by gift (in trust or otherwise) or at death. Additionally, the STEP Act would tax unrealized gains of assets held in trust every 21 years. A $1 million exemption would be available to offset any realization upon death (with a $100,000 exemption for lifetime transfers), and the tax would be payable in installments over a 15-year period for gains attributable to specific illiquid assets such as a family farm or business. Additionally, transfers to spouses or contributions to charity would generally be excluded from realization.

While estate taxes would remain due on the assets, capital gains would be deductible from a decedent's gross estate. Note that the STEP Act would apply retroactively, effective starting January 1, 2021.

Notably, the Biden campaign proposed higher capital gains tax rates for individuals (and presumably estates) with adjusted gross income (AGI) above $1,000,000. Specifically, capital gains would be taxed at ordinary rates for taxpayers with AGI in

excess of $1 million. With the added net investment income tax of 3.8% coupled with a proposed increase in the top marginal ordinary rate from 37% to 39.6%, the applicable capital gains rate may be as high as 43.4%. After deducting against estate taxes, the total tax burden can approach 70% for low basis assets in larger estates. For many sizable estates, the capital gains realization will add to the total transfer tax burden all the same, as illustrated in the following examples of estates of $5 million or $10 million (with assumed basis as indicated):

Total Potential Taxes at Death		
Estate value	**$5,000,000**	**$10,000,000**
Basis of assets	$2,000,000	$5,000,000
Gain realization (net of $1M exemption)	$2,000,000	$4,000,000
Capital gains taxes due (23.8% and 43.4% rates)	**($672,000)**	**($1,540,000)**
Estate exemption	$3,500,000	$3,500,000
Capital gains deduction	($672,000)	($1,540,000)
Estate taxes (Net of Exemption)	**($372,600)**	**($2,232,000)**
Total taxes as % of estate	**20.89%**	**37.72%**

Planning considerations in light of potential bills

Lifetime Gifting of Excess Exemption

In response to the various proposals in the Senate, larger estate owners specifically may wish to evaluate the transfer tax benefits of large lifetime gifts. Note that gifts of high basis assets may be the safest option if the STEP Act is likewise enacted in its current form, however, gifts to grantor trusts should avoid the retroactive gain recognition of the STEP Act and the inclusion of the Sanders Act if effected prior to enactment. The tax savings available from the current excess exemption, both in the near term and in the future, can be illustrated as follows:

2021 Exemption amount	**$11,700,000**
Excess over $3.5 million	$8,200,000
Estate tax savings from excess (@ 45%/50% tax rate)	**$3,775,000**
Future value in 20 years (@ 5% growth)	$21,757,041
Estate tax savings from excess (@ 45%/50% tax rate)	**$10,553,521**
Additional estate tax savings from excess $2.5M gift	**$1,859,960**

These results are further magnified for married couples, as well as where valuation discounts may be employed through the use of non-managing interests in LLCs, limited partnership interests or non-voting shares of closely held stock. Of course, for large gifts, trust planning is frequently advisable for the aforementioned asset protection benefits provided. Many individuals who are hesitant to make large lifetime gifts solely for future estate tax savings may employ **spousal lifetime access trusts** to include a spouse as beneficiary (and possibly trustee), as well as give a trust protector or third party broad power to amend a trust or exercise a power of appointment over the trust if tax laws or family circumstances change.

Life Insurance Trust Considerations

Because many irrevocable life insurance trusts are both considered grantor trusts and designed to require ongoing annual gifts to fund premiums, the grantor trust estate inclusion coupled with annual gift in trust limits make a review of existing life insurance trusts imperative for many individuals with such trusts in place. Approaches to consider prior to enactment of any legislation might include:

- **Large lump sum gifts** for future insurance funding;
- **Gifts of assets that produce income** that can be used for future premium funding;
- **Loan arrangements** moving forward to avoid making a "contribution" to a grantor trust; or
- The possibility to **"toggle off"** grantor trust status through a mechanism with the trust if necessary for funding post enactment. Alternatively, a non-grantor trust might be established for purposes of decanting or merging the existing trust property, including life insurance.

For ILITs established after enactment, funding strategies may be limited and new product and planning approaches may be necessary to maximize tax savings. For example, careful design to ensure that an ILIT is considered a non-grantor trust may be necessary to permit ongoing gifts to the trust for premium funding needs. Conversely, survivorship life insurance may be specifically attractive for estate tax liquidity planning. A **Survivorship Standby Trust** arrangement may be employed, whereby the spouse with the shorter life expectancy serves as the policy owner and leaves the policy to a properly structured credit shelter trust with other estate assets to provide ongoing premium funding, removing death proceeds in excess of then cash/policy value from the taxable estate.

Longer Term Planning Considerations

Because of the restraints that the Sanders bill would impose on many wealth shifting arrangements in trust, it is possible that family limited partnerships and family limited liability companies may be more regularly employed for generational planning as well as enhanced asset management and protection. Certain partnership freeze arrangements may also gain increased prominence when designing such entities to replace GRATs and grantor trust sale strategies. The scope of ownership in family investment entities may also be broadened among close friends and other families to take advantage of valuation discounts that are disallowed in the direct family context.

Due to the graduated estate tax rates, as well as the tax inclusive nature of estate taxes, larger estate holders may be much more inclined to pay gift taxes during lifetime to effect desired wealth shifting and family legacy plans as well. So long as the donor survives the payment of gift taxes by three years, the gift taxes paid by the donor are no longer included in the taxable estate. Such planning benefits can be illustrated by the following example of a married couple with a $20 million estate:

Estate Tax (Tax Inclusive)	
Taxable estate value	**$20,000,000**
Estate tax exemption	($7,000,000)
Net taxable estate	$13,000,000
Estate taxes	$5,850,000
Net to heirs	**$14,150,000**

Gift Tax (Tax Exclusive)	
Taxable estate value	**$20,000,000**
Taxable gift	$10,000,000
Gift tax exemption	($2,000,000)
Net taxable gift	$9,000,000
Gift taxes payable	$3,600,000
Net estate remaining	**$6,400,000**
Estate tax exemption remaining	($5,000,000)
Net taxable estate	$1,400,000
Estate taxes	$630,000
Net to heirs from estate and gift	**$15,770,000**

Note that many states that impose a state estate tax have increased the state exemption levels as the federal exemption has increased. For example, New York currently has a state tax threshold (in 2021) just shy of $6 million. If the federal exemption is reduced to the $3.5 million level, it is probable that a number of states' legislatures would explore a reduction in their state threshold as well, especially considering the fact that state estate taxes remain deductible against federal estate taxes. Such changes would increase the overall estate tax exposure faced by decedents domiciled in such states. Additionally, trust funding clauses under many client planning documents are designed with state and/or federal exemption maximization and tax deferral in mind. A significant change in the federal and/or state exemption levels could have unintended consequences for taxes and desired bequests under current planning documents.

Prospects for passage of proposed legislation

The prospects for passage of any significant tax legislation is always difficult to predict, but the current high levels of deficit spending and federal debt (approaching levels not seen since World War II) would generally mitigate in favor of meaningful tax increases at some point. The partisan divide and very narrow margins between the political parties, however, creates an unpredictable environment. Under Senate filibuster rules, significant legislation generally requires a 60-vote threshold for passage. The proposed tax changes are highly unlikely to garner the support of 10 Republican senators, so budget reconciliation (utilized to pass the massive ARPA COVID relief bill by a simple majority) may act as the Democratic legislative strategy moving forward. The question, therefore, will center on which legislative priorities can fit within the reconciliation framework. President Biden's infrastructure bill includes revenue measures in corporate tax increases, while also addressing many of his climate agenda objectives. Other priorities such as immigration or health care might qualify for reconciliation, depending on the direct budgetary impact of the bill. Additionally, proposed tax bills could potentially be added to any infrastructure legislation. Notable among provisions in President Biden's recent budget proposal (separate from the infrastructure bill described above) was a 10.4% increase in funding for the IRS, likely to enhance compliance and oversight.

Action items

While it is difficult to know which specific proposals will become law or when, it is vital for potentially affected individuals and business owners to remain in contact with their professional advisors to stay abreast of legislative developments and the potential impact on their respective situations. Immediately pressing matters:

- Review the potential impact of estate taxes under new exemption threshold and tax rates and evaluate sources of liquidity needed for bequests, asset preservation, taxes, and other needs.
- Review current generational wealth planning strategies under existing planning documents in light of potential new GST tax rules, as well as trust arrangements funded with gifts and/or sales of property and the impact of potential changes to the grantor trust rules.
- Review existing life insurance arrangements to assess ongoing funding needs as well as the impact of viable funding strategies and the current tax status of the trust in the event some or all of the proposals become law.
- Lastly, consider accelerating certain shifting arrangements prior to enactment of legislation. Note that proper trust drafting as well as the creation, funding, and appraisal of family business entities may take considerable time. Identification of suitable assets to shift, the impact of potential gain realization, manner in which transfers will be effected, the tax status of trust vehicles, and options to modify arrangements should laws subsequently change will all need to be considered. As is always the case, optimal results are generally not achieved when implementation is done in haste.

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