

September 28, 2021

## House Committee Reconciliation Bill Requires Clients to Act Now to Lock In Estate Tax Savings

The House Ways and Means Committee recently submitted its proposed language for the massive reconciliation bill to the House Budget Committee. The bill provides insight into a potential compromise deal between moderate and progressive Democrats to enact significant tax reform and increase taxes to fund their social agenda. Based on a review of this bill, clients with potentially taxable estates of \$10 million or more should act now to preserve their current \$11.7 million exemptions and reduce future estate tax liability. The following is only a summary of potential provisions that may impact clients.

### Current Environment

Currently, the top income tax rate is 37%, and the top long-term capital gain rate is 20%.

Under the Tax Jobs and Cuts Act of 2017 (“TJCA”), the base estate tax exemption was temporarily increased from \$5.0 million to \$10 million and indexed for inflation from 2011. For 2021, the estate tax exemption under current law (the TCJA) is \$11.7 million per person. The annual gift tax exclusion remains at \$15,000 per donor, per beneficiary. The TCJA is scheduled to “sunset” for any gifts or estates after December 31, 2025.

### Reduction in Federal Gift, Estate, and Generation-Skipping Transfer Tax Exemptions – Effective December 31, 2021

The bill would roll back the sunset date under the TJCA from December 31, 2025, to December 31, 2021. Clients who are contemplating large gifts, or who want to make gifts to preserve the temporary exemption that will be lost after the sunset should act now to complete those gifts by December 31, 2021.

### Inclusion of Irrevocable Grantor Trusts in Grantor’s Taxable Estate – Effective on Date of Enactment

A common technique to implement large gifts is to transfer assets to an irrevocable grantor trust. The irrevocable grantor trust (“IGT”), sometimes called an intentionally defective grantor trust (“IDGT”) or spousal lifetime access trust (“SLAT”), can include the grantor’s spouse and descendants as beneficiaries. The bill provides that any irrevocable grantor trust created after the date of enactment, or assets transferred to an existing irrevocable grantor trust after the date of enactment would be included in the grantor’s estate. This effectively eliminates the irrevocable grantor trust as an estate tax reduction tool for future use. However, existing irrevocable grantor trusts would not be subject to this rule, so action is required now to get this tool in place or to fund additional assets to an existing trust before the date of enactment.

### Distributions From Irrevocable Trusts Taxed as Gifts – Effective on Date of Enactment

Additionally, any distribution from an irrevocable grantor trust created or funded after the date of enactment would be treated as a gift, potentially causing a transferred asset to be subject to gift tax twice, once when the trust is funded and again when assets are distributed out of the trust.

### **Sales to Irrevocable Grantor Trusts Deemed Income Tax Realization Event – Effective on Date of Enactment**

Transactions between the grantor and the irrevocable grantor trust are not considered income tax realization events under current law. These transactions allow grantors to transfer additional wealth above their available exemption amounts through part-gift, part-sale transactions to irrevocable grantor trusts. In this type of transaction, the grantor creates and funds an irrevocable grantor trust with a gift, using some or all of the grantor's available gift tax exemption, and sells additional assets to the trust, in exchange for a promissory note. Payments from the irrevocable trust back to the grantor are not recognized by the grantor as taxable income because the trust is treated as being the owner for income tax purposes.

A primary benefit of this type of transaction is that the growth and appreciation from the transferred asset occurs outside the grantor's taxable estate free of the estate tax. The bill would eliminate this technique after the date of enactment and treat these transactions as taxable transactions.

### **Elimination of Valuation Discounts in Related Party Transactions – Effective on Date of Enactment**

One way to supercharge the sale to the irrevocable grantor trust is to transfer non-controlling, non-majority assets in a closely-held business to the irrevocable grantor trust. Because the assets being transferred do not have control, the value of the transferred assets can be discounted from their proportional value of the business. This creates immediate estate tax savings by allowing the grantor to transfer assets to the irrevocable grantor trust for 60-70 cents on the dollar. The bill would eliminate the use of valuation discounts in many cases for transfers occurring after the date of enactment.

### **Raising of Top Long Term Capital Gain Rate to 25% – Effective on Date of Announcement**

The current bill increases the top long-term capital gain rate to 25% for any sales occurring on or after the date of enactment for married filing joint taxpayers with adjusted gross income above \$400,000. There is a transitional provision for this year for transfers occurring before the date of announcement or which were subject to a binding agreement to sell before the date of enactment but that closes later in the year.

### **What Isn't In the Bill?**

While the bill eliminates a common and powerful estate tax savings technique, there are some notable provisions that were not included:

- Reduction of gift tax exemption to \$1.0 million and reducing estate tax exemption to fixed \$3.5 million
- Elimination of step-up in basis at death
- Deemed income tax realization events on distributions or upon grantor's death of highly appreciated assets (like family farms and family owned businesses) in irrevocable grantor trusts
- Increase in the capital gain rate to equal ordinary income tax rates for adjusted gross income filers with income of \$1.0 million or more
- Elimination of portability
- Restriction / new limits on annual gifts

Although not included in the House bill, there is still the possibility that these items may be added as part of the reconciliation process or through amendments to the current draft.

### **Potential Trap – Irrevocable Life Insurance Trusts**

A common irrevocable grantor trust is an irrevocable trust used to own life insurance ("ILIT"). Most clients fund the ILIT by making annual gifts to the ILIT equal to the premiums for any life insurance owned by the ILIT. If the bill passes, future payment of premiums or gifts to pay the premiums will taint the irrevocable trust and cause some or all of the death benefit of the life insurance to be included in the grantor's taxable estate for estate tax purposes. Clients and advisors should check with their estate planning attorney before making future premium payments or gifts if the reconciliation bill is enacted.

**What Should Clients Be Doing? Who Should Act?**

*Married clients whose combined net worth is less than \$12.0 million (or less than \$6.0 million if single)* – No action is required unless future tax proposals drop the estate tax exemption below \$6.0 million per person.

*Combined net worth greater than \$12 million* – Immediately implement aggressive use of irrevocable grantor trusts to shift wealth out of the estate tax system while minimizing transfer taxes and maintaining flexibility to address future changes. Creation and funding must be completed before the date of enactment.

**Without a Known Deadline, Some Clients May Not Complete**

Unfortunately, even for clients who act immediately, it may not be possible for them to complete their transfers before the date of enactment. Additionally, clients who delay because of current news reports that seem to suggest nothing will happen may miss the opportunity to plan if Democrats reach a compromise bill that passes in a few days.

If you have questions about this Alert, to discuss any of these techniques in detail, or how these recommendations apply to a particular circumstance, please call Dan Peare, Hugh Gill, or Ryan Farley at 316.631.3131.

*Dan Peare   Hugh Gill   Ryan Farley   Maggie Robertson*

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