Private Client and Family Office

Remember Our Advice to Prepare for Estate Tax Changes Sooner Rather Than Later? Later is Now.

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During the last few days of March, the For the 99.5 Percent Act (the "For the 99.5% Act") was introduced in the United States Senate, and details were released concerning the Sensible Taxation and Equity Promotion Act ("STEP Act"). Both of these bills would make dramatic changes that would increase taxes on lifetime gifts and after an individual's death and would either eliminate or decrease the effectiveness of the estate planning strategies now used.

We have been discussing the possibility of changes such as these for over a year now and encouraging our clients to proactively plan in preparation. When the election resulted in Democratic control of both the Presidency and Congress, we expected that proposals such as the For the 99.5% Act and the STEP Act would be introduced.

While it is still early in the legislative process, the chances of significant changes are growing and the window for action is closing. For those individuals who said they would deal with these issues "later" - Later is now.

Proposed changes in the For The 99.5% Act

For deaths or transfers occurring after 12/31/21:

- Reduce the estate tax and generation skipping transfer tax exemptions to $3.5 million per person or $7 million for married couples (from the current $11.7 million per person or $23.4 million per couple).
- Reduce the gift tax exemption to $1 million (from the current $11.7 million per person).
- Raise estate and gift tax rates (from the current 40% rate for taxable estates of any size) to:
  - 45% - For the portions of taxable estates between $3.5 million and $10 million
  - 50% - For the portions of taxable estates between $10 million and $50 million
  - 55% - For the portions of taxable estates between $50 million and $1 billion
  - 65% - For the portions of taxable estates in excess of $1 billion.

For trusts created or transfers made after the legislation's enactment:

- Limit annual exclusion gifts to $10,000 per donee with a cap of not more than two such gifts per taxpayer per year (capping annual exclusion gifts at $20,000 in gifts per donor annually). This limitation would apply to gifts made to "Crummey trusts," such as irrevocable life insurance trusts (ILITs).
- Limit the effective duration of existing and new dynasty or generation skipping trusts by eliminating generation skipping transfer tax exempt status after 50 years. Dynastic or generation skipping trusts would face additional transfer taxes when making distributions or terminating after 50 years.
- Restrict the use of grantor retained annuity trusts (GRATs) by increasing the minimum term to 10 years and requiring the remainder interest to have a value that equals at least

25% of the original assets. Although this restriction does not eliminate GRATs, it would render them unusable for the vast majority of people.

- Include new grantor trust assets in grantor's taxable estate for estate tax purposes. Irrevocable grantor trusts (aka intentionally defective grantor trusts) have become very popular and effective. Currently there is no relationship or connection between the grantor trust treatment of these trusts for income tax purposes and inclusion of these trusts in the taxable estates of the grantors for estate tax purposes. Under the proposed legislation, new grantor trusts created after the effective date of the law would be included in the grantor's estate. In addition, portions of existing grantor trusts to which additional contributions are made would also be included in the grantor's taxable estate.
- Treat distributions from grantor trusts during the grantor's lifetime as a gift subject to the gift tax. This rule would apply to new grantor trusts and to portions of existing grantor trusts to which contributions are made after the effective date.
- Treat the relinquishment of grantor trust treatment during the grantor's lifetime as a gift subject to the gift tax. Again, this rule would apply to new grantor trusts and to portions of existing grantor trusts to which contributions are made after the effective date.
- Eliminate valuation discounts for "passive assets," including cash, marketable securities and certain real estate, owned by entities such as partnerships and limited liability companies and for family-controlled enterprises.

Changes proposed in the STEP Act

Current tax law "carries over" the income basis of property given away during the donor's lifetime, and the recipient assumes the donor's income tax basis of the assets received. The current law treats transfers at death differently by adjusting the income tax basis of assets to fair market value upon the owner's death. This allows for the basis of your assets to "step up" to fair market value when assets are passed to the beneficiaries of your estate and avoids capital gains taxes on appreciation of assets during the owner's lifetime.

President Joe Biden indicated during his campaign for the White House that he would do away with the basis adjustment. While this campaign promise could be met by requiring the new owners to assume the deceased owner's tax basis after the owner's death (so that lifetime transfers and transfers at death would both have "carry over" basis), the STEP Act would go much further.

Subject to narrow exceptions, the STEP Act would treat transfers (other than to grantor trusts) during lifetime and at death as taxable events by treating the assets as having been sold. Specifically, the bill proposes to:

- Treat property as being sold for its fair market value when transferred by gift to an individual during lifetime, by gift to a non-grantor trust during lifetime, and following death.
- Although a transfer of property to a grantor trust would not be a taxable event, the property would be treated as having been sold if the property is transferred to another person (for example, it is distributed to a beneficiary), when the grantor of the trust dies, if the grantor trust treatment is terminated while the grantor is alive, or when the grantor trust would not be includible in the grantor's estate for estate tax purposes if the grantor dies.
- Treat property in non-grantor trusts as being "sold" for fair market value every 21 years, and capital gains taxes would be due. Trusts formed in 2005 or earlier would have their first deemed realization in 2026.
- Treat as sold any property that is no longer included in an owner's taxable estate, including, for example, property that is in a grantor trust.
- Require "large" trusts to report items such as trustees, grantors and beneficiaries, along with the trust's balance sheet and income statement, to the IRS.
- Unlike the For the 99.5% Act, the STEP Act would be retroactive and would apply to all transfers occurring **after December 31, 2020.**

The bill includes some very limited provisions to restrict the impact of the "deemed sale" rules.

- It would exempt the first $1 million in capital gains from taxes.
- It would exclude capital gains on personal residences (up to $250,000 for individuals and $500,000 for a married couple) and retirement accounts (which were never eligible for a basis adjustment at death).
- It would allow taxes assessed on illiquid assets or those assessed under the 21-year rule for non-grantor trusts to be paid in installments over 15 years under rules similar to the existing rules for payment of estate taxes in installments.

Is there still time to act?

It's early in the legislative process, and it is not clear whether these proposals will survive the legislative process intact or how they will be modified. However, if you didn't act last year because you thought the Republicans would control the Senate, or you weren't quite ready to act or you didn't think that proposed changes would affect you, it is time to discuss your options, make plans and act while you still can.

People who may need to make estate planning changes before potential tax changes are enacted include:

- Individuals who have not used up all of their current $11.7 million ($23.4 million for married couples) estate, gift and generation skipping trust tax exemptions and who can afford to make gifts that bring their total lifetime gifts to an amount higher than $3.5 million ($7 million for married couples).
- Individuals with estates above $3.5 million and married couples with estates above $7 million, each of whom will be affected by the decrease in exemption.
- Those making annual exclusion gifts in excess of $20,000 per year. This especially includes individuals who have life insurance trusts being funded by annual exclusion gifts.
- High net worth individuals or couples without grantor trusts. Creating one now may give you flexibility later.
- Owners of family or closely held businesses who want children and grandchildren to continue to own the business.

Note that this is the third time in recent years that legislation has been proposed that would severely reduce transfer tax exemptions, raise tax rates on high net worth families and eliminate common estate tax planning strategies. In case the third time really is the charm, we are encouraging clients to do proactive planning now to be prepared in the event that any of these changes are enacted.

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Mark chaired the State Bar of Michigan committee that spent more than five years writing the Michigan Trust Code, which governs how trusts are established and administered in the state. He is a Fellow of the American College of Trust and Estate Counsel.

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