

## Proposed Legislative Changes to Federal Estate, Gift and Trust Taxation

H.R. 5376, known as the Build Back Better Act (the “Act”), was introduced in the House of Representatives on September 27, 2021. While negotiations are ongoing in terms of the specifics of any final legislation, if the Act or legislation similar to the Act is signed into law, such law could have substantial implications for gift, estate and trust planning going forward. Based on the Act, many of these changes could be effective as soon as the date of the law’s enactment, so clients should give careful consideration to their estate and gifting plans at their earliest opportunity.

A brief overview of some of the currently proposed gift, estate and trust tax changes included in the Act are as follows:

### **Estate, Gift and Generation Skipping Transfer (“GST”) Tax Exemption Amount**

#### *Current law*

Currently, for U.S. citizens and domiciliaries, the lifetime exemption from estate and gift tax (and GST tax) (the “Exemption”) is \$10 million per each individual, indexed for inflation (in 2021, that amount was \$11.7 million). This amount is effectively doubled for married couples.

#### *What’s the proposed change?*

The Act would reduce the Exemption to \$5 million per each individual, indexed for inflation (in 2022, if the Act passes in its current form, the Exemption is estimated to be \$6.02 million). Again, this amount would effectively be doubled for married couples.

#### *What would be the effective date?*

This change would take effect after December 31, 2021.

#### *Planning to consider*

Clients may consider using the current Exemption through lifetime gifting, including by use of certain trusts, before the Exemption is lowered.

## Grantor Trusts

### *Current law*

Grantor trusts are trusts that are deemed owned by the grantor (or another person) for income tax purposes as a result of the inclusion of certain powers in the trust instrument. If properly structured however, the assets of the grantor trust can be deemed to be out of the grantor's estate for estate tax purposes (this is sometimes known as an "Intentionally Defective Grantor Trust" or "IDGT"). Currently, IDGTs may be desirable for a number of tax reasons. For example, the future income attributable to the trust assets is taxed directly to the grantor. As a result, the grantor pays the income taxes due on the trust assets, allowing those assets to grow on an income tax free basis inside the trust. Under current law, the payment of these income taxes by the grantor is not treated as a gift. Additionally, under current law, sales or transactions between the grantor and his or her grantor trust are generally not recognized for income tax purposes, meaning that there should be no tax recognition event on such a sale.

### *What's the proposed change?*

Based on the draft proposal, creation of a grantor trust or contributions to an existing grantor trust following the date of enactment of the Act would result in the inclusion of the trust, or a portion of it, in the grantor's estate for estate tax purposes on death, and distributions would generally be treated as taxable gifts (except for distributions to a grantor's spouse or to discharge an obligation of the grantor). There is ongoing uncertainty as to what constitutes a "contribution" for these purposes. Also, after the date of enactment of the Act, if the grantor trust status terminates as to all or a portion of a trust during the grantor's lifetime, such portion of the trust's assets would be treated as being gifted by the grantor at such time for gift tax purposes.

In addition, sales and other transactions between grantor trusts (which might include grantor trusts that were formed and funded prior to enactment of the Act) and the grantor would be taxed the same way as sales to third parties, meaning that there would be an income tax realization event.

The above rules would not apply to revocable trusts or trusts that otherwise would be includible in the grantor's estate for estate tax purposes.

### *What would be the effective date?*

These rules would apply after the date of enactment of the Act.

*Planning to consider*

These proposed rules would mean that use of grantor trusts in connection with lifetime estate tax planning, including IDGTs, Irrevocable Life Insurance Trusts, Qualified Personal Residence Trusts and Grantor Retained Annuity Trusts, may not be desirable following the enactment of the Act. Therefore, it may make sense to explore this planning now.

In addition, the ongoing treatment of existing (or soon-to-be formed) grantor trusts should be analyzed based on the proposed changes in the Act.

**Limitation on Valuation Discounts***Current law*

Currently, when valuing interests in entities for estate and gift tax purposes, discounts for lack of marketability and lack of control supported by an appraisal may apply, depending on the specifics of the entities involved. This would have the effect of lowering the value of the asset for estate and gift tax purposes, which could lower the tax exposure or usage of the Exemption.

*What's the proposed change?*

The Act would disregard the entity structure for “nonbusiness assets” (passive assets held for the production of income and not used in connection with the active conduct of a trade or business) and determine the value as if the grantor had transferred the underlying assets directly. This limits the ability to reduce the value of those assets by means of the traditional discount metrics. Assets used in an active business still can be discounted.

*What would be the effective date?*

This provision would be effective after the date of enactment of the Act.

*Planning to consider*

To the extent clients are considering making gifts or other transfers of entity interests that may be impacted, those clients should consider accelerating that planning so that the transaction can take place before the enactment of the Act, when more robust valuation discounts may be available.

## **Estate and Non-Grantor Trust Federal Income Tax, Capital Gains Tax and Surcharge Rates**

### *Current law*

The top federal income tax rate for estates and non-grantor trusts is currently 37%, and the top federal capital gains tax rate is 20%.

### *What's the proposed change?*

The top federal income tax rate for estates and non-grantor trusts would increase to 39.6%. The top federal capital gains tax rate would also increase to 25%. Estates and non-grantor trusts would also be subject to a 3% tax surcharge on modified adjusted gross income (which includes ordinary and capital gains income) over \$100,000.

Notably, the higher federal income tax rates, capital gains tax rates and 3% surcharge apply at lower thresholds for estates and non-grantor trusts than for individuals and grantor trusts.

### *What would be the effective date?*

These changes would mainly apply after December 31, 2021, but the change to the federal capital gains tax rate would have a retroactive application to September 13, 2021.

### *Planning to consider*

A review of existing structures should be considered to ensure tax efficiency going forward.

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