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Hurry Up and Wait: Impact of Proposed Tax Law Changes in the US on Wealth Planning

Over the past few weeks there have been several tax reform proposals released to the public, including those contained in President Biden's "American Families Plan." We summarize some of the notable proposed changes that would influence wealth planning and high-level considerations, below.

It is premature to assume any of the recent proposals will be passed by Congress, as they will likely be subject to significant debate and modifications.

More importantly, we emphasize that in most cases it is too early for taxpayers to engage in any type of significant tax planning pursuant to these proposals. Nevertheless, taxpayers should be aware of the proposed changes and should stay informed as the various bills move through Congress. If taxpayers do decide to make changes to their tax plans for other reasons while the legislation is pending, consideration should be given to the proposed changes so that steps are not taken that may negatively impact their tax situation after new legislation is enacted. In addition, once any applicable changes have been enacted, taxpayers should consult their tax advisors on tax planning opportunities.

Among the proposed legislative and policy changes are the following:

1. **Increasing audits and enforcement of high-income taxpayers.** To combat underreporting and underpayment by wealthy taxpayers (i.e., taxpayers with income greater than $400,000), the IRS would be given additional resources to audit and enforce payment by large corporations, businesses, estates, and higher-income individuals. Furthermore, financial institutions would be required to file information returns on taxpayer account flows, thereby subjecting taxpayers' investment and business activity to heightened reporting.

2. **Restoring the pre-TCJA top income tax rate to 39.6%.** The Tax Cuts and Jobs Act of 2017 (the "TCJA"), signed into law by President Trump on December 22, 2017, reduced statutory tax rates at almost all levels of taxable income, including the tax bracket for the highest earners, which dropped from 39.6% to 37%. Under the proposed legislation the restored 39.6% tax rate would apply to taxpayers with income greater than $400,000.

3. **Raising the capital gains tax rate to 39.6% for households earning more than $1 million.** If this capital gains tax rate increase is enacted, the top 0.3% of all households would pay 39.6% on all of their income. However, the 3.8% net investment income tax would continue to apply to investment income, which would then subject applicable taxpayers to a maximum federal income tax rate of 43.4%.

4. **Repealing step-up basis treatment of inherited assets for gains in excess of $1 million.** Assets inherited at death with built-in gain in excess of $1 million (or $2.5 million per couple) would no longer benefit from a basis step-up to fair market value. The proposed legislation would tax unrealized gains on death or give heirs a carryover basis in the property they inherit (i.e., heirs would generally "inherit" the decedent's historic cost basis). Exemptions are contemplated for assets donated to charity and for certain family-owned businesses and farms.

5. **Imposing a capital gains tax on lifetime gifts of capital assets with unrealized appreciation.** Current law provides that when a taxpayer makes a gift of property during his or her lifetime, the donee takes over the donor's historic cost basis and the donee pays capital gains tax on built-in gain only if/when the property is later sold. Proposed legislation would instead impose a capital gains tax on the donor at the time of the gift (as if sold to the donee), and the donee would receive the property with a fresh basis equal to its fair market value.

6. **Subjecting carried interest income to ordinary income tax rates.** In an effort to close the carried interest "loophole" benefiting hedge fund and private equity partners, carried interest income would no longer be subject to preferred capital gains rates and would instead be treated as ordinary income.

7. **Ending the Section 1031 like-kind exchange rules for high-value real estate.** Real estate investors would no longer be able to defer capital gains tax by exchanging like-kind property, if the gains exceed $500,000.

At this time, there are no concrete proposals regarding any changes to the federal gift and estate tax regimes or the applicable gift and estate tax exemption, which was doubled by the TCJA and currently stands at $11.7 million. Absent any action, under the TCJA the current exemption is set to sunset in 2026 and revert to $5 million (as adjusted for inflation). Further, the proposals are silent as regards to any change in the current $10,000 limitation for the deduction of state and local taxes (known as the "SALT" deduction) in calculating an individual's adjusted gross income for federal income tax purposes.

In addition to the increased gift and estate tax exemption under the TCJA, several individual income tax provisions are set to expire on December 31, 2025, and revert to their pre-TCJA structure. Such expiring provisions include the increased standard deduction, the increased child tax credit, the increased alternative minimum tax (AMT) exemption and phase-out, and the qualified business income deduction for pass-through income. Several important pre-TCJA taxpayer friendly provisions will also return, however, absent Congressional action, including uncapped SALT deductions, personal exemptions, and miscellaneous itemized deductions.

Below is a sample of high-level considerations that arise in light of some of the foregoing proposals.

<u>Grantor Trust Planning</u>

Under one of the proposals, property transferred to a grantor trust will be treated as if it was sold for its fair market value when the grantor is no longer deemed to own the trust assets for income tax purposes or if the property would no longer be included in the grantor's estate (i.e., if the transfer to the trust is a completed gift). Capital gains taxation would also occur if the trust property is distributed to any person other than the grantor.

If this proposal is included in the final legislation, it would dramatically affect so-called "intentionally defective grantor trust" ("IDGT") planning, which is a staple of modern estate planning. IDGTs are trusts that are generally designed to be completed gifts for gift and estate tax purposes under which the grantor retains certain powers that cause him or her to be deemed to own the trust assets for income tax purposes. This generally enables the grantor to sell assets to the trust without incurring capital gains tax and to shift assets in excess of the $11.7 million exemption gift tax free to the next generation because the trust is not responsible for paying income taxes. These benefits would no longer exist under the proposed legislation.

For example, any distribution of appreciated property from a grantor trust to anyone other than the grantor would be deemed to be a sale, and a capital gains tax would be imposed at the time of transfer. Under current law a recipient of appreciated property from a trust takes over the trust's historic cost basis in the asset and capital gains tax is imposed only when the property is sold by the donee. With respect to new trusts, property transferred to the trust would be deemed sold for its fair market value on the date of the transfer if the transfer is structured as a completed gift. With respect to existing trusts, a taxable transfer would be deemed to occur upon the grantor's death or when another event occurs causing termination of grantor status.

This proposed legislation would also impact "grantor retained annuity trust" ("GRAT") planning. Gains on appreciated property held by a GRAT would be taxed when the annuity period ends, because that is when the grantor ceases to be considered the owner of the trust property for income tax purposes. Similarly, planning with a "qualified personal residence trust" ("QPRT") would be affected because taxation of deemed gains would occur upon termination period that the grantor retained the right to live in the residence, again because this is when grantor trust status ends. While planning with grantor trusts might still be desirable for estate tax purposes, taxpayers would need to balance the benefits and negative consequences of taxation of deemed capital gains.

Taxpayers considering planning with grantor trusts while the proposed tax legislation is pending may consider embedding mechanisms to unwind or redirect transfers. For example, disclaimer provisions could be included in newly settled trusts which could result in the donated property reverting to the grantor if the trustees and/or beneficiaries exercise the disclaimer power.

<u>Revocable Trusts</u>

Under current law, appreciated assets held in a properly structured revocable trust receive a basis step-up upon the death of the grantor. Under proposed legislation such basis step-up would no longer be available, and the estate of the grantor would be taxed on the associated capital gains.

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Decanting

Decanting from a non-grantor trust is the process of appointing property from an existing trust to a new trust for one or more of the beneficiaries of the original trust. It is not clear whether this process would be treated as a transfer triggering a deemed sale of the transferred assets under the proposed legislation. While the new legislation may have an entirely different framework for the treatment of decanting, there is a substantial body of IRS guidance that characterizes a trust decanting as a non-taxable event when certain conditions are met. Out of an abundance of caution, to avoid an unintended capital gains tax, taxpayers planning trust decanting this year while the proposed legislation is pending should consider including provisions allowing the trustee of the new trust to disclaim the transfer.

Tax Clauses/Debt Payment Clauses

If termination of grantor status of a trust is triggered by the grantor's death, property held in the trust would be deemed sold, and the decedent would owe capital gains taxes in connection with the deemed sale. While it is not entirely clear under the proposed legislation, this would likely be an income tax and as such would be a debt of the decedent's estate. The estate might not have sufficient assets to pay additional tax and/or taxation might disadvantage residual beneficiaries of the estate who are not beneficiaries of the trusts the property of which caused the capital gains tax. This would thwart the intent of the decedent because beneficiaries who are not receiving the trust assets would be responsible for the tax on those assets.

State tax allocation statutes and provisions in the decedent's estate planning documents might be unclear as to how the new tax should be allocated. Taxpayers may consider reviewing the tax clauses and debt payment clauses in their Wills and trusts and, if amendments can be implemented, make revisions to those clauses to try to address this issue even while legislation is pending. Admittedly this may be a difficult issue to address if the trust has no provisions that would require the trustee to pay taxes owed by the decedent.

Harvesting Capital Gains and Losses

Taxpayers may believe they do not need to maximize the use of their losses because their heirs will receive a basis step-up in their appreciated assets. Because the continuation of basis step-up is in jeopardy, taxpayers who have realized losses may consider selling appreciated assets to utilize these losses. Taxpayers who have both low-basis assets and unrealized losses may decide to harvest losses and gains. These strategies may also mitigate against a potential increase in the capital gains rate.

Non-US Taxpayers

Because the proposed legislation provides that gifts and bequests of appreciated property would be treated as sales, it appears that usual capital gains tax rules would apply to the deemed sale for all taxpayers. Nonresident aliens are not taxed on a sale of US situs assets, with certain exceptions (such as real property). This should mean that gifts and bequests by nonresident aliens of US situs assets would not result in capital gain taxes and that their beneficiaries would inherit their basis in assets transfer during life and upon death, if basis

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step-up is in fact repealed. In this case, if US beneficiaries sell or transfer property received from a foreign grantor at a later date, capital gains would be realized at that time.

Similarly, a death of a foreign person who is deemed to be an owner of a foreign grantor trust would not result in capital gain tax with respect to US situs property held by the trust, and the trust will retain its historic cost basis in the assets. Very often foreign grantor trusts hold foreign holding companies, and planning for such trusts with US beneficiaries involves filing an election with the Internal Revenue Service for the holding companies to be treated as disregarded entities (so called "check-the-box election"). As drafted, the proposed legislation does not appear to affect this planning. Moreover, because trusts could no longer be structured to ensure a basis step-up for the trust's assets, "check-the-box" election planning may become more popular.

If the final legislation were to include a capital gains tax on US situs property owned by nonresident aliens at the time of their passing, this would be a drastic change and would likely chill foreign investment in private and public companies in the United States.

While there are many uncertainties and the final legislation may differ substantially from the proposals, taxpayers should monitor this evolving situation closely.

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