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Estate planning update – House Ways and Means Committee tax proposal

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On September 13, 2021, the House Ways and Means Committee released its tax proposal (the Committee Proposal) for raising revenue to help fund President Biden's Build Back Better Act.

While much may change during the legislative process, if enacted in their current form, the Committee Proposal changes outlined in the "Estate Planning Related Highlights" below would have a significant impact on estate planning by (i) accelerating to the end of this year the reduction of the estate, gift and generation-skipping transfer (GST) tax exemption amounts that were doubled for a limited period of time during the last administration and (ii) changing dramatically the income and transfer tax rules with respect to grantor trusts, as well as valuation rules for certain transfers.

Given this uncertain environment for estate planning, clients should consider the following:

- Clients who have not yet taken full advantage of the current, increased gift tax exemption amounts should complete any planned gifts before the end of the year or, if such plans involve gifting to irrevocable grantor trusts, transfers to such trusts should be completed before the sooner of the end of the year and the date of enactment of any tax legislation that includes the transfer tax changes affecting grantor trusts.
- Clients who have already used all of their current gift tax exemptions but not all of their current GST tax exemptions should consider making late allocations of their GST tax exemptions to existing trusts that are not fully exempt from GST tax. Late GST allocations have no gift tax consequences.
- Married couples who plan to make gifts that, in the aggregate, will not exceed one spouse's available exemption amount might consider structuring and funding such gifts so they are all made by the same donor spouse (and electing not to split gifts on their gift tax returns) in order potentially to preserve more of the non-donor spouse's unused exemption remaining after the amounts are reduced.
- New York and Connecticut residents should consider the impact of related, state specific transfer tax rules on their gifting plans. Because Connecticut's gift tax exemption is currently lower than the Federal gift tax exemption, gifts above that threshold may generate Connecticut gift tax even if no Federal gift tax is due. In New York, although there is no state-level gift tax, gifts made within three years of death may generate New York estate tax even if the estate otherwise qualifies for an unlimited marital or charitable deduction.
- Clients with irrevocable life insurance trusts (which, by their nature, are grantor trusts) holding policies requiring additional premium payments may wish to consider some pre-funding of such trusts using available gift tax exemption, or to explore the trusts' options for borrowing to pay premiums.
- Clients considering whether to "decant" existing grantor trusts into further grantor trusts, or to divide or engage in other transactions with existing grantor trusts, should note that there may be room for interpretation of, or alterations made to, the scope of the currently proposed rule that would grandfather existing grantor trusts. Accordingly, such clients may wish to consult with counsel about advancing, or being prepared to implement, their plans on short notice as matters develop.

In addition, the Committee Proposal contains a number of other, very significant income tax changes (including increased ordinary income and capital gains tax rates for high earners, trusts and estates); of particular note are proposed limitations on certain types of investments currently available for IRAs, the elimination of Roth conversions for high

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earners beginning on January 1, 2022 and additional distribution requirements for retirement accounts exceeding $10 million in the aggregate. Clients with non-Roth retirement accounts may wish to explore with their financial advisers whether it makes sense to effectuate a Roth conversion before year-end.

Estate planning related highlights of Committee Proposal

January 1, 2022 – Accelerated date for reduction of estate, gift and GST tax exemptions

Under the Committee Proposal, on January 1, 2022, the estate, gift and GST tax exemption amounts, currently $11.7 million per individual ($23.4 million combined for a married couple), would be reduced to $5 million per individual ($10 million combined for a married couple), plus relevant inflation adjustment amounts. The Committee Proposal accelerates the timing for the reduction in the exemption amounts which, under current law, is scheduled to take effect at the end of 2025.

The reduced exemption amounts would apply to gifts made, and estates of decedents dying, after December 31, 2021.

Proposed changes affecting grantor trusts

The Committee Proposal would have a dramatic impact on planning with grantor trusts.

A grantor trust includes a trust where the grantor is treated as the owner of the trust property for Federal income tax purposes but not estate tax purposes. Under current law, transactions between a grantor and a grantor trust generally are disregarded for income tax purposes.

The proposed grantor trust legislation is broad in scope and, on its face, could affect many types of trusts, including GRATs, QPRTs and SLATs, as well as more common planning vehicles such as irrevocable descendants trusts and irrevocable life insurance trusts. This may prompt significant modifications to the relevant legislative provisions (particularly related to insurance trusts), but at this stage we cannot predict whether final legislation, regulations or IRS guidance will exempt certain types of grantor trusts or particular transactions with grantor trusts.

Under the Committee Proposal, a grantor trust created on or after the enactment date would be subject to the following transfer and income tax rules:

– At the death of the grantor, the trust's assets would be includible in the grantor's gross estate.
– Any distributions made from the trust during the grantor's lifetime (other than to the grantor or the grantor's spouse, or to discharge an obligation of the grantor) would be treated as a taxable gift made by the grantor to the recipient.
– If the trust ceased to be a grantor trust during the grantor's lifetime, the grantor would be treated as making a taxable gift of the assets then held in trust.
– To avoid double transfer taxation, there would be an adjustment for amounts previously transferred to a grantor trust that were treated as taxable gifts.
– Sales and exchanges between the grantor and a grantor trust (other than a revocable trust) would no longer be disregarded for income tax purposes and instead would be subject to the same income tax treatment as third-party transactions.

These changes would apply not only to grantor trusts created on or after the date of enactment of the legislation, but also to any portion of a grantor trust created before the enactment date that is attributable to a contribution made on or after the enactment date. There is currently no guidance as to how these rules might impact other events involving pre-enactment date grantor trusts such as decanting, exercise of powers of appointment and establishment of successor trusts under a pre-enactment date trust instrument.

Elimination of valuation discounts for transfers of non-business assets

The Committee Proposal would eliminate valuation discounts for transfers of interests in entities such as partnerships and LLCs that own nonbusiness assets – generally passive assets, such as cash, stock, bonds and real property (with exceptions) – not used in the active conduct of a trade or business. This change would apply to transfers made after the

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date of enactment of the legislation. Clients considering gifts of interests that currently would allow for valuation discounts should make such gifts prior to the date of enactment.

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If you have any questions regarding the matters covered in this publication, please reach out to any of the lawyers listed below or your usual Davis Polk contact.

Paula A. Ryan
+1 212 450 4611
paula.ryan@davispolk.com

Lucy McKinstry Taylor
+1 212 450 3112
lucy.taylor@davispolk.com

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