

TAX & WEALTH MANAGEMENT

ALERT

NOVEMBER 8, 2021

UPDATE: Proposed Changes to Federal Tax Code Affecting Tax and Wealth Management Clients

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UPDATE (11/8/21). Welcome to the legislative roller coaster! For now, we can all breathe a collective sigh of relief. On November 3, 2021, the U.S. House Rules Committee (the "Committee") released a third version of the Build Back Better bill, which includes updated guidance significantly narrowing the scope of the previously proposed changes to the federal tax code.

For details, see – https://rules.house.gov/sites/democrats.rules.house.gov/files/BILLS-117HR5376RH-RCP117-18.pdf

Most notably, the newly revised proposal eliminated the prior proposal's provisions that would have:

- Reduced the federal estate and gift exemption as of January 1, 2022 (although the "sunset" to the federal estate and gift tax exemption is still scheduled to occur at the end of 2025).
• Changed how grantor trusts are treated for income and estate tax purposes.
• Changed the valuation rules for transfers of nonbusiness assets.
• Increased the capital gains and top marginal income tax rates.

The third version of the Committee's proposal still includes a potential surcharge tax of 5% on the adjusted gross income over \$10,000,000 for individuals and over \$200,000 for estates and trusts, plus an additional 3% surcharge tax on adjusted gross income over

\$25,000,000 for individuals and over \$500,000 for estates and trusts.

For individuals who make over \$400,000 per year and have more than \$10,000,000 held in retirement accounts, this version of the proposal would also (1) prohibit those individuals from making contributions to retirement accounts and (2) require those individuals to make annual withdrawals of 50% of the aggregate value of their retirement accounts over \$10,000,000. In addition, if the same individual's retirement accounts exceed \$20,000,000, the individual would be required to annually withdraw from any Roth IRA and Roth designated account the lesser of (1) the amount needed to reduce the aggregate retirement account balance to below \$20,000,000 and (2) the entire balance of such Roth IRA and Roth designated accounts. Both of the proposed changes to retirement account withdrawals and contributions would become effective after December 31, 2028.

We provide this update to keep you informed, and will let you know more as the legislative process continues. Although nothing is final at this time, it is good to see the elimination of many of the prior tax proposals.

ORIGINAL ALERT (10/12/21). On September 13, 2021, the U.S. House Ways and Means Committee (the "Committee") released a draft of proposed changes to the federal tax code, including significant changes affecting trusts, estates, gifts and tax rates, among other proposals1. The most relevant of these modifications

1 This was the original proposal: https://waysandmeans.house.gov/sites/democrats.waysandmeans.house.gov/files/documents/NEAL_032_xml.pdf

are outlined below. Individuals are likely to need prompt legal assistance to make appropriate adjustments in response to these expected changes.

ESTATE AND GIFT EXEMPTION

Currently, individuals have an exemption from the federal gift and estate tax of \$11,700,000 (or \$23,400,000 for married couples), less any taxable gifts made during life. The generation-skipping transfer (“GST”) tax exemption amount is equal to the gift and estate tax exemption. These exemptions are increased each year for inflation.

The current law is scheduled to “sunset” at the end of 2025, at which time the estate, gift and GST exemptions will decrease to about half of their current amounts starting in 2026. The Committee’s proposal accelerates this sunset and decreases the exemptions to approximately \$6,020,000 per person (or about \$12,040,000 for married couples) beginning in 2022. For individuals who do not use all of the current \$11,700,000 of available exemptions during 2021, the approximately \$5,700,000 of proposed decrease in these exemptions may be forever lost.

GRANTOR TRUST TRANSACTIONS

Some of the most significant changes in the Committee’s proposal deal with trusts that are considered “grantor trusts” for income tax purposes. Grantor trusts are those trusts that are not included in the estate of the creator (or grantor) for estate tax purposes but treat the grantor as the owner for income tax purposes. Under the proposed changes, assets transferred to a grantor trust established or funded after the new law is enacted would be subject to possible (1) inclusion in the grantor’s estate for estate tax purposes and (2) recognition events for income tax purposes. In addition, a distribution from a grantor trust to persons other than the grantor or the grantor’s spouse would be treated as a taxable gift by the grantor during the grantor’s lifetime.

Existing grantor trusts would not be subject to these rules. However, to the extent there is a contribution made to an existing grantor trust after the date of enactment of the proposed legislation, the portion of the trust assets attributable to the contribution would be

subject to the new grantor trust rules. Such contributions would presumably include a gift or sale, and possibly other transactions. These rules would drastically reduce, if not entirely eliminate, the use of trusts such as spousal lifetime access trusts (commonly referred to as “SLATs”).

The proposed rules would also dramatically change the income taxation of grantor retained annuity trusts (“GRATs”). Specifically, under current law, when an annuity is paid to the grantor from the GRAT, there is no income tax consequence. However, under the proposed changes, there would be a recognition event for income tax purposes each time a GRAT annuity payment is made using appreciated property. In other words, each time the GRAT makes a required annuity payment to the grantor, the grantor would be responsible for income tax on the distribution as though the distribution were a sale (unless the distribution were made in cash).

VALUATION RULES FOR TRANSFERS OF NONBUSINESS ASSETS

The Committee has also proposed eliminating lack of marketability and fractional interest valuation discounts for interests in entities owned at death or gifted during a transferor’s life when such entities own non-business, or passive, assets including cash, stocks, personal property and other similar assets. Real property would also be treated as a passive asset unless the transferor “materially participates” in the management of the business.

OTHER TAX CHANGES

- The capital gains rate would increase to 25% (effective as of September 13, 2021).
- The top marginal income tax rate would be 39.6% for individuals making over \$400,000, and married couples making over \$450,000.
- A surcharge tax of 3% would be imposed on individuals with adjusted gross income of over \$5,000,000 and on estates and trusts with adjusted gross income over \$100,000.
- Individuals with retirement accounts having an aggregate value in excess of \$10,000,000 and who

make over \$400,000 (or \$450,000 for married couples), would be (i) prohibited from making additional contributions to their retirement accounts and (ii) required to make annual account withdrawals of 50% of the value over \$10,000,000 and 100% of the value over \$20,000,000.

WHAT ACTIONS SHOULD INDIVIDUALS TAKE?

Based on the proposed changes, individuals should consult with their trust and estate attorney to better understand what steps should be taken now, and how the Committee's proposal may affect their current estate planning. Many of the proposed changes will become effective immediately upon the Committee's proposal being enacted into law. For example, many of the changes under consideration would affect individuals who are contemplating utilizing their existing exemptions in 2021. Rather than waiting to see what tax code changes are ultimately adopted into law, prompt consultation is advised at this point. ♦

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