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Steve Leimberg's Estate Planning Email Newsletter - Archive Message #2911

Date:	**29-Sep-21**
From:	**Steve Leimberg's Estate Planning Newsletter**
Subject:	**Barry Nelson, Jennifer Okcular & Cassandra Nelson: How Your Estate Plan May Be Affected by Potential Changes to Income and Transfer Taxes under the House Ways and Means Committee Tax Proposal**

Barry A. Nelson, **Jennifer E. Okcular** and **Cassandra S. Nelson** provide members with a letter they recently sent to clients about the House Ways and Means Committee Tax Proposal.

Barry A. Nelson, a Florida Bar Board Certified Tax and Wills, Trusts and Estates Attorney and author of ***Estate Planning and Asset Protection in Florida: A Plan to Survive Unexpected Financial Threats***, is a shareholder in the North Miami Beach law firm of **Nelson & Nelson, P.A.** He practices in the areas of tax, estate planning, asset protection planning, probate, partnerships and business law. He provides counsel to high net worth individuals and families focusing on income, estate and gift tax planning, and assists business owners to most effectively pass their ownership interests from one generation to the next. As the father of a child with autism, Mr. Nelson combines his legal skills with compassion and understanding in the preparation of Special Needs Trusts for children with disabilities.

Mr. Nelson received the Distinguished Planner Award 2021 presented by the Estate Planning Council of Greater Miami. Mr. Nelson is a Fellow of the American College of Trust and Estate Counsel and served as Chairman of its Asset Protection Committee from 2009 to 2012. Mr. Nelson is named in Business and HNW Guide as a Tier 1 leading estate planning attorney in Florida. Mr. Nelson has been listed in The Best Lawyers in America since 1995 and is a Martindale-Hubbell AV-rated attorney. Mr. Nelson was named by Best Lawyers in America as the 2015 Trusts and Estates "Lawyer of the Year" in Miami.

As the founding chairman of the Asset Preservation Committee of the Real Property, Probate and Trust Law Section of the Florida Bar from 2004-2007, Mr. Nelson introduced and coordinated a project to write a treatise authored by committee members entitled Asset Protection in Florida

(Florida Bar CLE 2008, 5th Edition 2017). Mr. Nelson wrote Chapter 5 of Asset Protection in Florida, entitled "Homestead: Creditor Issues." Mr. Nelson is a co-founder and current board member of the Victory Center for Autism and Behavioral Challenges (a not-for-profit corporation) and served as board chairman from 2000-2008 and from 2020 to current.

Jennifer E. Okcular, is a shareholder in the law firm of Nelson & Nelson, P.A. in North Miami Beach, Florida, practices primarily in the areas of tax, estate planning, asset protection planning and probate administration. Jennifer is Board Certified by the Florida Bar in Wills, Trusts and Estates. Jennifer graduated first in her class from Stetson University College of Law in 2004 and received her LLM in Taxation at the University of Florida Graduate Tax Program. Jennifer received her B.A. from the University of Florida. Jennifer is an active in the local community as a sustainer of the Junior League of Miami, Inc., a women's organization that promotes volunteerism and as a member of the Ambassador's Legacy Council for the Miami Children's Hospital Foundation.

Cassandra S. Nelson, an associate in the law firm of **Nelson & Nelson, P.A.** in North Miami Beach, Florida. Cassandra is recognized in Ones to Watch in the practice area of Trusts and Estates in the 2022 edition of The Best Lawyers in America. She practices primarily in the areas of estate planning, asset protection, tax, special needs trusts, guardianships, and probate administration. She has co-authored articles published by Trust & Estates, ActionLine (Florida Bar), and Leimberg Information Services and has been a co-contributor on several chapters published in Mr. Nelson's treatise, ***Estate Planning and Asset Protection in Florida: A Plan to Survive Unexpected Financial Threats***. Cassandra received her B.A. from the University of Miami in 2013 and her J.D. from Emory University School of Law in 2017. Cassandra Nelson is involved with The Victory Center for Autism and Behavioral Challenges (a not-for-profit corporation). As the older sister of a 23-year-old brother with severe autism, Cassandra has a unique interest in assisting children with disabilities and their families. As an attorney, she does so by counseling on the creation of special needs trusts and establishing guardianships for such children.

Here is their commentary:

COMMENT:

We are publishing this letter a bit later than some excellent summaries that were issued over the last week or so by other publications and/or professionals after the House Ways and Means Committee released its tax law proposal to be incorporated in the budget reconciliation bill on Monday, September 13, 2021 (referred to hereinafter as the "House Proposal"). The House Proposal now has a number HR 5376 (which can be found at: **H.R.5376)**, and a Report (which can be found at: **H.R.5376 Report**).[1]

We wanted to absorb the House Proposal and determine if there would be any clarification as to areas that have caused confusion, as described below. Based upon our review of the House Proposal, helpful analyses by other professionals, and commentary from peers, we are providing this letter that is up to date as of September 22, 2021. The legislative review process will be multi-step and it is likely that many substantive changes will be made before any legislation becomes law. It is possible that some (if not all) of the tax law changes described herein will never be enacted. We are certain many more changes will be forthcoming, so seek legal or CPA advice before taking any action.

Very Truly Yours,

Barry Nelson
Jennifer E. Okcular
Cassandra S. Nelson

Summary of Potential Changes as a Result of the House Proposal

Based upon the House Proposal, the current $11.7 million gift and estate tax exemption could be reduced to approximately $6.03 million after December 31, 2021. As we prepare this letter, I grow increasingly concerned that trusts to be created to take advantage of the current gift and estate tax exemption must be executed before enactment of the House Proposal in its final form, which could possibly be much earlier that December 31, 2021 (as soon as the House and Senate agree on the House Proposal and the President signs it). Of course, the process could drag on, but nobody knows. As a result, a prudent approach is to have any new grantor trusts, such as SLATs or QTIPs (as described below) be created and funded as soon as possible. Estate planning attorneys may not have the capacity to prepare all of the documents their clients may need before enactment of the House Proposal. We are aware that the House

Proposal is only proposed legislation and that this could be a “fire drill” if Congress is unable to agree on a final bill. We are also aware that if Congress does agree on a final bill, it may differ significantly from the House Proposal. However, all we, as advisors, can do at this time is explain the House Proposal in its current form so that those that may be affected by it can consider their immediate options.

The good news is that the House Proposal does not: (i) address the elimination of the step-up in income tax basis from cost to fair market value at death; (ii) tax unrealized appreciation at death; or (iii) raise the current 40% estate, gift, and generation skipping transfer tax rate.

This summary only covers portions of the House Proposal that are most relevant to our clients. For example, any foreign tax issues will not be covered in this letter. The effective dates in the House Proposal differ. For example: (i) the reduction of the current $11.7 million gift and estate tax exemption to about $6.03 million will be effective January 1, 2022, (ii) capital gains increases will be effective for tax years ending after September 13, 2021 (when the House Proposal was introduced) and (iii) the grantor trust limitations described below will be effective upon the date of enactment. The Report provides the following effective date provisions with respect to grantor trusts (page 1282-1283 (top page numbers) and page 324-325 (bottom page numbers) of the Report): “The provision is generally effective for (1) trusts created on or after the date of enactment and (2) any portion of a trust established before the date of enactment that is attributable to a contribution made on or after such date. The portion of the provision relating to sales and exchanges between a deemed owner and a grantor trust is intended to be effective for sales and other dispositions after the date of enactment.” Although the effective date provision of the Report provides that the “any portion of a trust established before the date of enactment that is attributable to a contribution made on or after such date” it is unclear whether such provision applies to sales and exchanges for a grantor trust created before enactment.
A summary of the parts of the House Proposal that we believe are most relevant to our clients is below:

Individual Taxes

Tax rates: The top marginal individual income tax rate would increase from 37% to 39.6%. This marginal rate would apply to married individuals filing jointly with taxable income over $450,000; to heads of household with taxable income over $425,000; to unmarried individuals with taxable income over $400,000; to married individuals filing separate returns with taxable income over $225,000; and to estates and trusts with taxable income over $12,500.

High-income surcharge: The House Proposal would impose a surcharge tax equal to 3% of a taxpayer's modified adjusted gross income (MAGI) in excess of $5 million (or in excess of $2.5 million for a married individual filing separately). For this purpose, modified adjusted gross income means adjusted gross income reduced by any deduction allowed for investment interest (as defined in section 163(d)).

Capital gains: The House Proposal would increase the 20% tax rate on capital gains to 25%, effective for tax years ending after September 13, 2021 (note that President Biden had considered a 40% capital gains tax). However, a transition rule would provide that the current statutory rate of 20% would continue to apply to gains and losses for the portion of the tax year prior to September 13, 2021 and gains recognized after September 13, 2021 that arise from transactions entered into before September 13, 2021 pursuant to a written binding contract (and which is not modified thereafter in any material respect). **Note:** Most capital gains are also subject to an additional 3.8% tax.

Estate and Gift Tax Provisions

Gift, Estate, and Generation Skipping Transfer Tax Exemptions (effective for decedents dying and gifts made after December 31, 2021): The House Proposal would reduce the current $11.7 million exemption from gift, estate, and generation skipping transfer taxes (which is currently scheduled to sunset on December 31, 2025) to approximately $5 million per taxpayer, adjusted for inflation since 2011. In 2022, the exemption will be $6,030,000. This produces a $5,670,000 exemption drop from 2021 to 2022. While this is a substantial drop, future indexation effectively restores part of this $5,670,000 of “bonus exemption” for a taxpayer who did not fully utilize the current $11.7 million unified credit and lives beyond 2022. Taxpayers who feel comfortable making outright gifts of their remaining gift, estate, and generation skipping transfer tax exclusions should do so before January 1, 2022. However, gifts in trust, especially to grantor trusts (as described below) need careful analysis. **Note:** For reasons beyond the scope of this letter, taxpayers will only fully benefit from current exemptions by using their entire $11.7 million exemption (reduced by prior taxable gifts) as compared to making a gift of, for example, $5,670,000, which will not result in the effective use of the current $11.7 million exemption. This computation should be reviewed with taxpayer's tax advisor or with our firm if you are our client.

New Grantor Trust Rules Could Eliminate Benefits – General Explanation: While some of the House Proposal provisions are simple to comprehend and planning options are relatively clear, the House Proposal creates some confusion by eliminating the benefits of grantor trusts created and/or funded after enactment. Grantor trusts have been a significant planning technique for many of our clients for over 20 years.

Grantor trusts allow the creator (also commonly referred to as the settlor or grantor) to make a gift to a trust that, with proper planning, will be excluded from the creator's estate, and also allows the creator to pay income tax on all trust income without such payments being considered a gift to the trust or its beneficiaries. The rationale is that the trust creator is considered the owner of the trust income for income tax purposes, but not for gift or estate tax purposes because the trust provides the creator with one or more retained power, such as the power to substitute the creator's other assets for trust assets of equivalent value. As a result, the creator of the trust is obligated to pay income tax on trust income (both ordinary and capital gains) and because of such obligation, payment of income tax by the creator is not a gift to the trust or its beneficiaries.

An important benefit of grantor trust status is the ability of the creator during his or her lifetime to take the creator's high income tax basis assets and substitute such high basis assets for low or even negative basis assets of equivalent value that are owned by the grantor trust. Assets held in such a grantor trust do not benefit from a step up in income tax basis to fair market value upon the death of the creator whereas the law currently in effect allows a step up in basis to fair market value for assets owned by a person upon death. The House Proposal does not currently eliminate step up in income tax at death. Accordingly, as of the date of this letter, grantor trusts are a great estate planning techniques as they allow taxpayers who create grantor trusts to: (i) pay the trust's income tax and (ii) maximize income tax basis planning for assets owned by the grantor trust at the creator's death by allowing the creator to substitute the creator's high income tax basis assets for low or even negative basis assets of equivalent value before the creator’s death and thereby the creator’s beneficiaries benefit from a step up in income tax basis at death as to the low income tax basis assets owned by the creator as of his or her date of death.

As stated above, the House Proposal eliminates the ability to take advantage of grantor trust planning for any trust created or funded after enactment. However, trusts created before enactment should maintain full grantor trust benefits so long as the trust is not modified after enactment and there are no contributions to such trust. Grantor trust status will be eliminated, at least to some degree, based upon the value of post enactment contributions in the event contributions are made to the trust after enactment. As indicated above, the House Proposal is unclear as to whether a grandfathered trust will lose its grantor trust status if assets are substituted by the creator or sold by the creator to the trust subsequent to enactment. We expect the rules to be clarified in the future as to sales and substitutions of assets as to grantor trusts created and funded before enactment. However, we anticipate a race to create and fund new grantor trusts before enactment to take advantage of the grantor’s ability to pay income tax on grantor trust income and based upon the possibility that the law may be clarified to allow sales and substitutions for grandfathered trusts.

Based upon the House Proposal, it is also unclear whether modification of an existing grantor trust will result in loss of grantor trust status. Thus, for clients that have existing grantor trusts that may have outdated provisions including dispositive provisions, the best option may be to decant such trusts (based upon applicable state law and with care to maintain generation skipping transfer benefits after consulting with their attorney) into a new updated grantor trust and fully fund the new trust before enactment of the House Proposal. This may not be easy especially since it is unclear when enactment will occur. **Note:** The grantor trust provision will eliminate the benefits of techniques such as GRATs and inter vivos QTIP trusts as well as most life insurance trusts created or funded after enactment, and to a more limited extent, even pre-enactment life insurance trusts funded after enactment.

Grantor Trust Provisions in House Proposal - Estate Tax Inclusion (effective date: trusts created on or after the date of enactment (or to any portion of a trust that was created before the date of enactment

which is attributable to a contribution made on or after the date of enactment)): The House Proposal would essentially eliminate grantor trusts as a planning vehicle for any trusts created after enactment. Specifically, the House Proposal would add new Section 2901 to the Code, which:

- Includes in a grantor's taxable estate any portion of a grantor trust's assets of which the person is the "deemed owner" for income tax purposes.
- Treats a distribution made from a grantor trust as a gift, unless (a) the distribution is made to the grantor's spouse or (b) the distribution discharges an obligation of the deemed owner.
- Provides that if the trust's grantor status is terminated during the grantor's lifetime, the assets will be treated as being gifted at that time by the grantor. A "proper adjustment" will be made if assets of a grantor trust are included in the grantor's taxable estate to account for amounts previously treated as taxable gifts by the grantor to the trust.

Grantor Trust Provisions in House Proposal - Income Taxation on Sales to Grantor Trusts (effective date: trusts created on or after the date of enactment (or to any portion of a trust that was created before the date of enactment which is attributable to a contribution made on or after the date of enactment)): Under existing law, when a grantor sells appreciated assets to a grantor trust, no capital gain is triggered. In addition, under existing law, the "swap" or "substitution" of assets of equal value for assets in a grantor trust does not trigger capital gain. The House Proposal would add new Section 1062 to the Code, which would require gain to be recognized on sales of appreciated assets to a grantor trust, but deny the recognition of a loss. Under new Section 1062, if enacted, "swap" or "substitution" transactions would no longer be free of capital gains tax consequences as to post enactment created grantor trusts. Furthermore, if a post-enactment "contribution" is made to a grandfathered trust a portion of that trust would be subject to these new rules. The term "contribution" is not defined and has caused much confusion, especially as to existing life insurance trusts where the trust creator typically makes annual trust contributions to pay the current year's life insurance premium. It is unclear whether sales or swaps to grantor trusts created before enactment will be subject to the new rules subjecting post-enactment sales or swaps to tax and, until further guidance is provided, such post-enactment transactions should be avoided.

Family Limited Partnership and Other Valuation Discount Limits as Non-Business Assets

The House Proposal seeks to limit the estate and gift tax valuation discounts applied to transfers of closely-held non-business assets. This provision is designed to limit the strategy of creating family limited partnerships to hold passive assets (i.e., a portfolio of stocks, bonds, mutual funds, any like type assets), and have the partnership valued for gift and estate tax purposes at a lesser value due to discounts for lack of marketability and minority interests. The Proposal defines “non-business assets” as passive-type assets, which is held for the production or collection of income and is not used in the active conduct of a trade or business. In other words, forming a family limited partnership or limited liability company and funding it with marketable securities would no longer be a viable technique for transferring marketable securities at a discounted value. This provision, if enacted, would apply to transfers after the date of enactment. Included in the valuation discount prohibition rule is passive real estate held in partnerships and LLCs. Currently, it appears that fractional gifts of interests in real estate (not owned in a business entity) could still qualify for valuation discounts, but such transfers could create catastrophic title issues such as where one owner of a small fractional interest does not agree to a sale or if such an interest is conveyed upon divorce to an ex-spouse.

Retirement Plans

IRA and Retirement Plan Provisions: The House Proposal creates significant tax increases, accelerates taxable withdrawals, and prohibits additions to IRAs of high income taxpayers who already have retirement assets in excess of $10 million and other modifications described below. If the House Proposal is enacted, taxpayers must consult with their retirement plan advisors to make sure they are in compliance.

Contributions to IRAs: The House Proposal would prohibit further contributions to a Roth or traditional IRA for a tax year if the total value of an individual's IRA and defined contribution retirement accounts generally exceeds $10 million as of the end of the prior tax year. The limit on contributions would only apply to single taxpayers (or taxpayers married filing separately) with taxable income over $400,000, married taxpayers filing jointly with taxable income over $450,000, and heads of household with taxable income over $425,000 (all indexed for inflation) ("high-income taxpayers").

Required Minimum Distributions: For high-income taxpayers, as defined in the preceding item, whose combined traditional IRA, Roth IRA, and defined contribution retirement account balances generally exceed $10 million at the end of a tax year, a minimum distribution would be required for the following year as follows:

- If the individual's prior-year aggregate traditional IRA, Roth IRA, and defined contribution account balance **exceeds the $10 million limit, but is less than $20 million**, 50% of the value in excess above $10 million must be distributed as taxable income.
- If the individual's prior-year aggregate traditional IRA, Roth IRA, and defined contribution account balance **exceeds $20 million**, 100% of the value in excess above $20 million must be distributed as taxable income.

Roth conversions: The House Proposal would eliminate Roth conversions for both IRAs and employer-sponsored plans for single taxpayers (or taxpayers married filing separately) with taxable income over $400,000, married taxpayers filing jointly with taxable income over $450,000, and heads of household with taxable income over $425,000 (all indexed for inflation). This provision would apply to distributions, transfers, and contributions made in taxable years beginning after December 31, 2021. This provision would also prohibit all employee after-tax contributions in qualified plans and after-tax IRA contributions from being converted to Roth regardless of income level effective for distributions, transfers, and contributions made after December 31, 2021.

Moving Forward – Before a Bill Passes

There are numerous planning techniques that can be initiated now, before the House Proposal (or any negotiated revised proposal) is enacted. Specifically, clients who were considering Spousal Limited Access Trusts ("SLATs"), Grantor Retained Annuity Trusts ("GRATs"), or sales of discounted partnership or LLC interests using their remaining gift, estate, and generation skipping transfer tax exclusions, selling assets to a grantor trust, or substituting assets into a grantor trust for other assets of equivalent value (if authorized in such grantor trust), should act now before enactment. For those concerned about asset protection planning, inter vivos QTIP trusts can provide excellent results. However, creating inter vivos QTIP trusts before enactment is necessary to avoid the possibility of double estate tax inclusion should the creator die before his or her spouse.

Clients with family limited partnerships and/or limited liability companies that hold passive assets should consider whether gifts or sales of partnership or LLC interests should be made before enactment.

Clients who have used their entire gift tax exemption but have GST tax exemption remaining may make a gift equal to their remaining GST tax exemption and pay the gift tax on such gift and, provided the donor lives three years from the date of the gift, the gift tax paid will be removed from the donor's estate.

If you wish to initiate planning before the House Proposal is enacted, call your attorney, CPA, and/or financial advisor soon as there is only limited time to act before enactment.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Barry Nelson

Jennifer Okcular

Cassandra Nelson

CITE AS:

[1] The Report, due to file size limitations, is provided in eight portions. Our link is to portion three. Portion three includes page numbers on the top and different page numbers on the bottom. The page number that deals with the explanation as to grantor trusts starts on top page number 1280 and bottom page number 322.