

# Time May Be Running Out for Estate Tax Saving Opportunities

by Michael D. Whitty

## A FREEBORN & PETERS LLP CLIENT ALERT

**Estate Planning in the third quarter of 2021** is driven by the advance in Congress of legislation that would substantially curtail some of the most powerful techniques for reducing gift and estate taxes. This legislation would need to pass through the Congressional reconciliation process. **This Client Alert provides information on three hot topics:**

**1. House Issues Proposed Tax Legislation:** The US House Ways and Means Committee majority issued a summary of its proposed tax legislation. A few provisions carry an effective date of September 13, 2021, the date the report was issued, but most provisions have an effective date of January 2022 or later. This Bulletin includes a summary of the major changes proposed by the House.

**2. Fourth Quarter of 2021 Will Likely Be Last Opportunity to Use Certain Powerful Estate Tax Savings Techniques:** The House proposals target several powerful estate tax savings techniques, and would prohibit or effectively eliminate several as of the date of enactment, including completed gift grantor trusts and valuation discounts for transfers of family-owned entities. Other major changes would occur as of the end of 2021, including halving of the exemptions for gift tax, estate tax, and generation-skipping transfer tax ("GST Tax").

**3. Limited Estate Tax Savings Techniques After Legislation Becomes Effective:** Once legislation resembling the House proposals becomes effective, many of our most powerful and popular estate and gift tax savings techniques will be eviscerated, if not eliminated. There will still be some techniques that remain available, but those will not be as powerful.

Our prior 2020-21 Client Alerts ([found here](#), [here](#), [here](#), [here](#), and [here](#)) addressed other topics that remain current:

- Health Care Documents and Estate Plans in the Face of **Coronavirus**
- Planning for Retirement Accounts After the **SECURE Act** of 2019
- The New **Illinois Uniform Trust Code** and Its Effects on Trust Design
- Planning for Possible Changes in **Estate and Gift Tax Exemptions**
- Gift and Intra-family Loan Refinancing Opportunities with **Low Interest Rates**
- Popular and Powerful Wealth Transfer Techniques May Be **Curtailed By Congress**
- How 2021 Is Shaping Up for Estate Planning Opportunities

If any of these topics raises concerns or questions for you, contact one of the Freeborn & Peters LLP attorneys listed below.

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**All of our clients who are serious about reducing estate tax exposure should arrange a call to discuss how to best take advantage of the opportunities presented by current conditions of favorable valuations and historically low interest rates, as well as the currently high estate and gift tax exemptions that will be reduced by the end of 2025, if not sooner, by proposed legislation.**

## 1. Introduction:

On Monday, September 13 the Democratic majority of the House Ways and Means Committee released a summary of tax proposals, which progressed on Wednesday, September 15 when they voted to advance the proposals to the House Budget Committee. The summary was very detailed, and trying to condense it for this Bulletin is like trying to drink from a fire hose. Some caution is warranted because **these proposals are not yet the law**. The Senate and its Finance Committee may have differences of opinion and approach, and may further amend any bill that actually passes. The final House and Senate bills would have to be reconciled and sent to the President's task for signature before such legislation becomes law. However, designing and implementing estate planning initiatives to beat the deadline takes **more time than would be available** if a taxpayer waited for final enactment of the legislation.

## 2. Summary of House Tax Proposals:

The proposals from the House majority of the House Ways and Means Committee (the "House proposals") would go beyond rolling back much of the TCJA 2017 tax act and would make many fundamental changes to income, gift, and estate taxes. The House proposals did not include every change that had received serious discussion, however. Our summaries in this Bulletin will give priority to proposed changes to estate and gift taxation and the income taxation of trusts, because several of the more important changes in those areas have an earlier effective date than almost all of the proposed changes to individual income tax and corporate taxation, and steps to achieve estate and gift tax savings take more time to design and implement.

### A. Stages of Effective Dates.

The House proposals do not include uniform effective dates for all provisions. Instead, they are almost all within three phases, as set forth in Table 1 below.

Table 1: Stages of Effective Dates in House Proposal	
Category of Provisions	Effective Date
<ul style="list-style-type: none"> <li>Capital Gains Top Tax Rate Increase to 25%</li> <li>Qualified Dividends Top Tax Rate Increase to 25%</li> </ul>	Date of Introduction: September 13, 2021*
*The "date of introduction" was the date the Democratic majority on the House Ways and Means Committee introduced their proposal.	
<ul style="list-style-type: none"> <li>Changes to Grantor Trust Rules</li> <li>Elimination of Valuation Discounts on Gift or Estate Taxable Transfers of Passive or Portfolio Assets in a Privately Held Entity</li> </ul>	Date of Enactment**
**The date of enactment will be the date the legislation is signed by the President. If it passes at all, it will almost certainly be before year-end.	
<ul style="list-style-type: none"> <li>Almost all other provisions in House Proposal, including all mentioned in this Bulletin</li> </ul>	January 1, 2022

### B. Immediate Changes to Capital Gains and Qualified Dividends.

The proposing members chose to make the increase in the long-term capital gains and qualified dividends top tax rates from 20% to 25% immediate, upon date of introduction on **September 13, 2021**. This increase was less than earlier proposals that would have brought the rate up to 28% or even 39.6%. The 3.8% Net Investment Income Tax would continue to apply, raising the effective top rate to 28.8%. Assuming the bill passes including that provision, this is the only proposed change **effective immediately**, even before the date of enactment, because the proponents expected that giving taxpayers a period of time to sell assets at the current rates might cause either a stock market selloff, a rush of special dividends, or both.

## C. Changes Effectiveness on Date of Enactment.

Two major changes relevant to wealthy taxpayers seeking to minimize estate and gift taxes will be effective on the as-yet-to-be-determined date of enactment.

**Grantor Trust Changes.** One will be changes to the estate taxation of **grantor trusts** and the income taxation of transactions between a grantor trust and the trust's grantor, as set forth in **Table 2** below.

**Gift and Estate Tax Valuation Changes.** The other will be **elimination of valuation discounts** for gift and estate tax purposes for passive or portfolio investments held in a family-held entity. If the family-held entity conducts an active business, then that portion not representing passive or portfolio investments within the entity will still be eligible for valuation discounts.

## D. Changes Effective January 1, 2022.

The vast majority of the House proposals are effective for tax years beginning after December 31, 2021. A few are deferred for a short time after that date. The following would all be effective for 2022 and later unless indicated otherwise.

**Transfer Tax Changes.** Estate, gift, and GST tax exemptions would be reduced to the 2010 level of \$5,000,000 plus post-2010 inflation, effective after 12/31/2021. Before taking into account the as-yet-unknown inflation adjustment for 2022, this would halve the current \$11,700,000 exemption to \$5,850,000; current projections for 2022 would result in an exemption of \$6,020,000. This is an acceleration of the cut in the exemptions already in current law but effective after December 31, 2025.

Partly offsetting that cut in the estate tax exemption, at least for certain taxpayers, would be an amendment of Section 2032A special use valuation to increase the allowable reduction in real property used in a farm or active business from \$750,000 to \$11,700,000.

**Table 2: Current and Proposed Changes to Taxation of Grantor Trusts, Effective Date of Enactment (If House Proposal Enacted)**

Revocable Trusts Under Current Law (Not Affected by Proposed Legislation)	Irrevocable, Completed Gift Grantor Trusts Under Current Law	Grandfathered Portion of Grantor Trust, After Proposed Legislation	Non-Grandfathered Portion of Grantor Trust, After Proposed Legislation	Non-Grantor Irrevocable Trusts, Now and After Proposed Legislation
Inclusion in Taxable Estate for Estate Tax Purposes:				
Included	Not Included	Not Included	<i><b>Included</b></i>	Not Included
Contributions Subject to Gift Tax:				
Not gift taxable	Gift taxable			
Distributions (other than to Grantor) Subject to Gift Tax:				
Gift taxable	Not gift taxable	Not gift taxable	<i><b>Gift taxable</b></i> , but possibly with offset for previous taxable gifts	Not gift taxable
Sales and Exchanges Between Grantor and Trust (proposed new Section 1062) (including exercises of Substitution Power and In-Kind Distributions from GRATs):				
Not taxable		Taxable (as trade or exchange)		

**Individual Income Tax Changes.** The top personal income tax rate would be increased from 37% to 39.6%. In addition, higher adjusted gross incomes (AGI) will be subject to an additional 3% surtax. The thresholds at which those rates will apply are set forth in **Table 3** below.

**Payroll Tax on High Earners.** The 12.4% payroll tax used to fund Social Security will apply to income over \$400,000. Corporate and Business Tax Changes. The top corporate income tax rate would be increased from 21% to 26.5%, hitting 28% on corporate income over \$5,000,000. The minimum tax on US companies' foreign subsidiaries would increase from 10.5% to 16.5% (lower than the original 21% proposal). In addition, a new 15% minimum tax on book income would be applied, slashing the profits of corporations legally reduce their taxable income below their book income reported for shareholders and lenders.

The Code Section 199 income tax deduction for pass-through entities (partnerships, LLCs, Subchapter S Corporations) will be phased out over the range of \$400,000 to \$500,000 of income, resulting in an effective rate of 71% due to this phaseout over a relatively narrow bracket. In addition, a 3.8% surcharge will be added to pass-through active income. The minimum holding period for carried interest to receive long-term capital gains treatment would be increased from three years (imposed in the TCJA 2017 tax act) to five years.

## E. Changes to IRAs and Qualified Retirement Plans.

So-called “**Mega-IRAs**” would be hit by more tax under the House proposal. Taxpayers with over **\$10,000,000** of aggregate retirement account balances (IRAs, 401ks, etc.) would be subject to **accelerated and increased minimum distributions** and limitations on additional contributions. The proposal would require an enhanced minimum distribution of 50% of the excess of the taxpayer's aggregate retirement account balances over the \$10,000,000 threshold, measured as of the start of the year. If the aggregate retirement balances exceed \$20,000,000, then the enhanced minimum distribution must be taken from Roth IRA accounts first. Because such enhanced minimum distributions would be required by law, they would not be subject to a 10% surtax for distributions made before age 59 <sup>1/2</sup>.

**Table 3: Thresholds for Top Individual Income Tax Rate Bracket and 3% Surtax on High Adjusted Gross Incomes**

Taxpayer Type	Top Personal Rate of 39.6% Applicable to Income Above	Surtax of 3% Applicable to Modified Adjusted Gross Income Above
Married Filing Jointly	\$450,000	\$5,000,000
Head of Household	\$425,000	\$5,000,000
Single	\$400,000	\$5,000,000
Married Filing Separately	\$225,000	\$2,500,000
Trusts and Estates	\$12,500	\$100,000

**Status Investments and Substantial Interest Investments:** In addition, IRAs and qualified plans will no longer be able to defer income on investments that require the owner to certify to a certain status. This will affect investors in **private placement investments** who have to certify status as either an Accredited Investor or Qualified Purchaser. The proposal provides for a two-year transition period for IRAs owning such assets as of date of enactment; the rules otherwise are effective January 1, 2022.

Another proposal for IRAs and qualified plans would prohibit such accounts from holding any investment in a privately held corporation, partnership, trust, or estate in which account owner owns at least 10% of the entity or serves as an officer of that entity (designated as “substantial interest investments”).

**Roth Conversions Limited:** Finally, Roth conversions (conversions of regular IRAs to Roth IRAs) would be prohibited for taxpayers with incomes subject to the top rate as shown in **Table 3** above, effective after December 31, 2031 (the ten year delay is to collect revenue on the conversions within the scoring period for the legislation).

## F. Other Notable Income Tax Changes

- Intangible drilling costs for oil and gas wells will no longer be immediately expensed, but would be capitalized and depreciated like tangible drilling costs.
- Wash sale rules that now apply to securities would apply to **cryptocurrency**, currencies, and commodities; losses would be deferred if the seller purchased the same asset within 30 days.
- **Syndicated conservation easements** (where promoters organize partnerships or LLCs to purchase a property, grant a conservation easement, and share the conservation easement deduction) where the deduction exceeded 250% of the partners' basis would lose the conservation easement deduction, **retroactive** to December 2016.

## G. Bullets Dodged: Changes Proposed in Earlier Versions of Legislation That Did Not Become Part of the House Proposals.

The House proposals did not include several changes that received serious consideration in prior proposals:

- No changes to the specific rules for grantor retained annuity trusts ("GRATs") found in Code §2702, although GRATs would be impacted by the changes in grantor trust rules as discussed above.
- No caps on annual exclusion gifts.
- No proposal to eliminate step-up or to tax capital gains at death, and no taxation of unrealized capital gains at date of death or gift transfer.
- No elimination of Section 1031, which allows tax-free exchanges of real estate.
- No novel provisions as favored by Senators such as Sanders and Warren, such as a wealth tax or a 15% minimum tax on book income and a 2% excise tax on stock buybacks.
- **Tax Rate Increases and Gift Tax Limitations.** The House proposal did not include (i) proposals to increase the main tax rate for estate, gift, and GST Tax or to add a new top rate of 65%, (ii) the proposal to lower the estate and GST tax exemption further to \$3,500,000 and the gift tax exemption to only \$1,000,000, or (iii) the proposal to limit the GST Tax exemption to only 50 years.

## 3. Fourth Quarter of 2021 May Be Last Opportunity to Use Certain Powerful Estate Tax Savings Techniques:

Assuming legislation resembling the House proposals becomes effective, there will be a limited window time to utilize many of our most powerful and popular techniques for reducing estate and gift taxes. The following are some techniques that should be implemented promptly by those taxpayers for whom such techniques are a good fit.

- Create **new grantor trusts** while those can still be **grandfathered**.
- **Spousal Lifetime Access Trusts ("SLATs")**, which are always grantor trusts while the grantor's spouse holds a beneficial interest, should be created while those can still be grandfathered.
- Max out on **contributions to existing grantor trusts** before the effective date (date of enactment) of changes to grantor trust treatment. This includes finding of **irrevocable life insurance trusts ("ILITs")**, which previously might have been funded with annual contributions to pay insurance premiums but now should be pre-funded as much as possible before the House proposals are enacted.
- Likewise, make **installment sales** to existing grandfathered grantor trusts.
- Consider **low-interest cash loans** to existing grandfathered grantor trusts, as to which the interest component of debt service should remain a non-taxable item.
- **Exercise substitution powers** over existing grantor trusts before the date of enactment makes such transfers taxable events; this can be used to extract trust investments that have already seen their best days of growth and replace them with new investments with better appreciation potential.
- Cancel notes from prior installment sales or loans to family trusts to make quick and easily valued gifts.
- Make Roth IRA conversions while you can do so at today's tax rates.

## 4. Limited Estate Tax Savings Techniques After Legislation Becomes Effective:

Once legislation resembling the House proposals becomes effective, many of our most powerful and popular estate and gift tax savings techniques will be eviscerated, if not eliminated. There will still be some techniques that remain available, but those will not be as powerful.



Some of the techniques and concepts to follow after the effective date of legislation like the House proposals include:

- Keep grantor trust status for grandfathered irrevocable grantor trusts, pay the taxes for them, but make no more installment sales or substitutions unless the resulting capital gains tax is an acceptable cost.
- No new Spousal Lifetime Access Trusts (“SLATs”), as those by definition will be grantor trusts and their usefulness will be curtailed as described above.
- Make **cash loans at low interest rates** to both grantor and non-grantor types of irrevocable trusts; this will allow those trusts invested for growth to grow faster with the resulting leverage, and will also be a partial “estate tax freeze” to limit the growth of the lender’s taxable estate. Unlike installment sales, cash loans will not trigger capital gains taxes.
- **Preferred interests in entities** such as family partnerships and family LLCs have not been targeted by the House legislation, so opportunities will remain to establish an estate tax freeze by retaining a Code §2701-compliant preferred interest and giving away common interests.

## 5. Interest Rates Still Low, But Trending Upward

The IRS released the October 2021 Applicable Federal Rates on September 16, 2021, which continued a trend toward slightly increased rates since the September 2020 rates that were the lowest since AFRs began to be issued. These are set forth in **Table 4** below. These rates are “safe harbor” rates used to assure there is no imputed additional interest for income or gift tax purposes.

Table 4: Applicable Federal Rates for October 2021: The Section 7520 rate is 1.0%				
The AFRs are as follows:	Annual	Semi-Annual	Quarterly	Monthly
Short-term (up to 3 years)	0.18%	0.18%	0.18%	0.18%
Mid-term (3 to 9 years)	0.91%	0.91%	0.91%	0.91%
Long-term (over 9 years)	1.74%	1.73%	1.73%	1.73%

As discussed in greater detail in our June 2020 Client Alert bulletin, these rates offer savings not only for clients seeking to reduce estate tax exposure, but also for clients seeking to reduce their family members’ interest expenses through refinancing. While the rates have been on a slightly upward trend since September 2020, they remain low when considered in historical context, and future rates may be much higher once the Federal Reserve ever sees a need to combat inflation.

The techniques that use the Applicable Federal Rates to provide estate and gift tax savings include intra-family loans and loan refinancing, installment sales to grantor trusts, and Grantor Retained Annuity Trusts (GRATs). All these techniques remain valuable for transfers that shift future growth and appreciation without gift taxes, **at least until Congress curtails those techniques** (as discussed above).

In addition, the low Section 7520 Rate provides opportunities for certain techniques, validated by the tax laws, that use this rate to compute the present value of a retained or charitable interest. These techniques include the grantor retained annuity trust (“GRAT”) and the charitable lead annuity trust (“CLAT”), described in detail in our June 2020 Client Alert bulletin.

**ITEM TO WATCH – POSSIBLE REGULATION OF FAMILY OFFICES:** The recent collapse of the Archegos family office due to risky leveraged investments has drawn attention to family offices and some proposals to limit or eliminate the “family office exception” to the SEC registration requirements that would otherwise apply. Those proposals may not get past the “reality check” that the risky investments could have been made by the individuals involved without the family office being involved. We will be monitoring the proposals just in case, as they may have some impact on whether and when families would want to form a family office.

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**Freeborn & Peters COVID-19 Task Force, with dozens of COVID-19 related Client Alerts and links:**

<https://www.freeborn.com/practice/covid-19>

**Bill Russell's White Paper on client result using a GRAT:**

<https://www.freeborn.com/perspectives/real-life-example-transferring-growth-without-gift-tax>



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