What Planners Need to Know About the Build Back Better Act

Proposed legislation provides both estate planning threats and opportunities.

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On Sept. 13, the House Ways and Means Committee, led by Chairman Richard E. Neal (D-Mass.), released its plan to pay for the $3.5 trillion Build Back Better Act (the Act). The legislation contains a variety of changes across the Tax Code, but the following summary focuses on the provisions that most directly impact estate tax planning. **It's important to stress that this remains proposed legislation that will inevitably undergo further revisions before it's passed by the House and taken up by the Senate.** Note that several of the provisions discussed below will become effective as soon as the legislation becomes law, so taxpayers may not have all of 2021 to respond.

Decrease the Gift and Estate Tax Exemption

The Tax Cuts and Jobs Act (TCJA) signed into law by President Trump in 2017 temporarily doubled transfer tax exemptions to $10 million, adjusted for inflation. As a result, the gift, estate and generation skipping transfer (GST) tax exemptions are each $11.7 million per person in 2021. Under the TCJA, the exemption is scheduled to decrease to $5 million adjusted for inflation on Jan. 1, 2026. The proposal accelerates that to 2022, meaning the transfer tax exemptions will roughly be cut in half as of Jan. 1,

2022. Those wishing to take advantage of the current higher exemptions should explore making gifts before the end of the year or allocating GST exemption to existing trusts that aren't currently GST exempt.

Valuation of Non-Business Assets

A common estate planning strategy is to transfer non-publicly traded or other hard to value assets and to have those assets appraised at the lowest defensible valuation. Under the proposed legislation, that approach will still be available for interests in operating businesses, but not for family entities funded with marketable securities.

Under the proposed legislation, when an interest in an entity is transferred, it must be valued in two steps. First, any "non-business assets" owned by the entity are valued as if they were transferred by the transferor directly. As a result, no valuation discount is permitted. Second, the interest in the entity that's being transferred is valued using the traditional "willing buyer-willing seller analysis," but the value of the non-business assets are ignored. This new valuation approach applies to transfers after the Act is enacted.

For example, if Operating LLC manufactured widgets and also owned $3 million of publicly traded stock, a gift of a 33% interest in Operating LLC to child would be valued as: (1) a $1 million gift of publicly traded stock, and (2) a gift of a 33% interest in Operating LLC, valued as though it didn't own any publicly traded stock.

Income Taxation on Sales to Grantor Trusts

For income tax purposes, a grantor trust is essentially treated as the alter ego of the grantor. As a result, the income and deductions associated with grantor trust assets are reported on the tax return of the grantor. For many years, estate planners have used the unique nature of a grantor trust to transfer wealth into trust, often by selling assets to the trust in exchange for a low interest rate promissory note. So long as the assets sold to the trust appreciated by more than the interest rate on the note, this strategy has proven effective for transferring wealth estate tax free.

Because of how grantor trusts are taxed, when a grantor sells appreciated assets to a grantor trust, no capital gain is triggered. Any interest payments on the associated promissory note are also income tax free. The proposed legislation would add new Section 1062 and require gain be recognized on such sales, but would deny the recognition of a loss. It appears that the treatment of interest on loans between a grantor and a grantor trust would continue to be income tax free.

It's also been common for a grantor to "swap" assets of equal value with a grantor trust. A grantor may do this to move high basis assets into the trust in exchange for low basis assets, to help diversify the trust's investment portfolio, to gain access to cash or other liquid assets held in the trust or for a number of other reasons. Once again, this transaction has historically been free of capital gains tax consequences, but that would apparently no longer be the case if the proposed legislation passes in its current form.

The proposed legislation would apply to grantor trusts, other than revocable trusts, created on or after the date the Act is enacted. Existing irrevocable trusts would be grandfathered, but if a "contribution" is made to a grandfathered trust, a portion of that trust would be subject to these new rules. The term "contribution" isn't defined.

Estate Taxation of Grantor Trusts

Perhaps the change with the widest impact on traditional estate planning strategy would be new Section 2901. Once again, these provisions will apply to trusts created on or after the date the Act is enacted, other than revocable trusts, or to that portion of a grandfathered trust attributable to contributions made after that date. The section has three key provisions:

1. When the deemed owner of a grantor trust dies, the assets of that grantor trust are part of the deemed owner's gross estate.
2. Any distribution from a grantor trust to someone other than the grantor, the grantor's spouse or to discharge a debt of the grantor will be treated as a taxable gift from the grantor to the person receiving the distribution.
3. If the trust ceases to be a grantor trust during the grantor's life, it will be treated as a gift by the grantor of all trust assets.

Perhaps the best way to understand how disruptive proposed Section 2901 would be is through an examination of how it would impact several common estate-planning strategies.

Grantor retained annuity trusts (GRATs). GRATs were ushered into existence in 1990 and are perhaps the most widely used advanced estate planning technique. The taxpayer transfers assets to a trust, and the taxpayer is entitled to a series of payments over the next two or more years that roughly equal the value of the contributed property. As a result, the taxpayer has made a net gift of almost zero (these are sometimes called "zeroed out GRATs"). If the assets appreciate, substantially all of that appreciation can pass estate and gift tax free to future generations, provided the grantor survives the GRAT annuity term.

If Section 2901 is codified, it appears GRATs will no longer be beneficial. At the end of the annuity term, if a GRAT transfers assets to a continuing grantor trust, the assets will still be subject to estate tax. If assets pass to a non-grantor trust or to children, the transferor will be treated as making a gift equal to the value of the transferred property. In either event, there's no benefit to creating a GRAT. The taxpayer would be better off simply making a gift of whatever size they desire. Furthermore, if appreciated assets are used to make the required annuity payment to the grantor, under proposed Section 1062, that payment would trigger a deemed sale and an unwanted capital gains event.

Insurance trusts. Insurance trusts are almost always grantor trusts. They're designed to ensure the insurance death benefit isn't subject to estate tax. The premium payments owed on the insurance policy are generally paid by making annual gifts to the trust.

Existing insurance trusts will be grandfathered, but the payment of future insurance premiums by the insured will be an additional contribution to the trust, resulting in some portion of the insurance death benefit being estate taxable. Tracking this portion will be challenging for many taxpayers. Going forward, if the insurance trust is a grantor trust, the death benefit on any trust owned insurance will be subject to estate tax. It will be difficult to craft an insurance trust that isn't considered a grantor trust with respect to the insured or the trust beneficiaries.

Spousal lifetime access trust (SLAT). A SLAT is a trust for a spouse and their descendants. In general, naming a spouse as a trust beneficiary results in that trust being classified as a grantor trust. As a result, going forward, it will be very difficult to create an irrevocable trust for the benefit of a spouse without subjecting the assets of that trust to estate tax.

Increased relief for certain real property used in farming or other trades or businesses

In certain circumstances, existing Section 2032A allows property used for farming or in a trade or business to be valued based on that use, and not on the true fair market value of such property. Effective Jan. 1, 2022, the maximum reduction in the value of that property will be increased from $750,000, adjusted for inflation since 1997, to $11.7 million adjusted for inflation going forward. There are a number of technical requirements under Section 2032A, but for those who qualify this proposal represents material relief from the estate tax.

What's Not Included?

As important as the proposed changes are, there are a number of other changes the estate- planning community was expecting that haven't been included in the proposed legislation at this time. The maximum tax rate remains 40%. There are no proposed changes to the GST tax or to the treatment of dynasty trusts. There's been some concern that the gift tax exemption would decrease to only $1 million, but it remains unified with the estate tax exemption. No changes to the gift tax annual exclusion are being made. Perhaps most importantly, unlike the original Biden proposal, this legislation doesn't include any provisions triggering capital gains tax when a gift is made or on the death of a taxpayer, nor are there any changes to the basis step-up rule.

End of Year Planning with New Legislation in Mind

While the current proposal is certain to change through the legislative process, for the first time we have specific legislation on which to base our end of year planning. Some of the changes are significant and would impact estate-planning strategies that have been used for decades. None of these changes, however, would become effective until final legislation is enacted. As a result, there's still time to review your clients' specific circumstances and to take whatever action best serves their overall planning goals.