Key Wealth Institute

Staying Ahead of Congress:

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Legislation Could Affect Your Estate Plan, Here's What You Can Do to Plan Now

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The Key Wealth Institute is a team of highly experienced professionals from across wealth management, dedicated to delivering commentary and financial advice. From strategies to manage your wealth to the latest political and industry news, the Key Wealth Institute provides proactive insights to help grow your wealth.

Tax legislation is not a promise, and a taxpayer has no vested right in the Internal Revenue Code." Justice Harry Blackmun, United States v. Carlton, 1994.

Unfortunately, this is the situation confronting both taxpayers and estate planners in the current tax environment. While there have been proposals from President Biden and various congressional representatives, a clearer picture[1] is forming with the House of Representatives Ways and Means Committee's (Ways & Means) $3.5 trillion spending bill issued on September 13, 2021. Yet waters are still somewhat muddied as the changes are set forth in 881 pages of proposed law. Although the bill contains many proposals, of particular concern are changes to the estate, income, and capital gains tax rates and to Grantor Trusts.

The latest Ways & Means proposal differs significantly in the estate planning context from the Biden proposal. Of note, the Ways & Means proposal retains the current step-up in cost basis at death. Similar in some respects to the Biden plan, the Ways & Means proposal moves to reduce the federal estate and gift tax exemption to $5 million (inflation-adjusted). This is a significant reduction from the current $11.7 million, however, the current top estate tax rate of 40% would remain. The effective date is January 1, 2022, and would not be applied retroactively.

Example: Decedent has $25 million estate and passes away in 2021 with the current $11.7 million estate tax exemption amount and having made no previous taxable gifts.

Current Law	
Taxable Estate	$25 million
Federal Tax Payable	$5.32 million
Taxes as % of Estate	21.3%

Proposed $5 million Estate Tax Exemption (With 40% Top Rate)	
Taxable Estate	$25 million
Federal Tax Payable	$8 million
Taxes as % of Estate	32%

Another aspect of the legislation is the expansion of the top income tax rates for individuals and trusts. The passage of the 2017 Tax Cuts and Jobs Act (TCJA) moved the top marginal rate to 37%. [2] With the proposal, the top marginal rate will return to 39.6% for those filers with taxable income of $400,000 (individual) and $450,000 (married filing jointly). For trusts and estates, the highest marginal rate is reached with taxable income of $12,500. As has always been the case, this is a significant difference.

Also included are changes to the 3.8% net investment income surtax and an extra 3% surtax for ultra-high earners with modified adjusted gross income (MAGI) exceeding $5 million (Trust MAGI at $100,000). For capital gains, the top rate will increase to 25% for individual filers whose taxable income exceeds $400,000 ($450,000 for married filing jointly). Of significance is that this rate would be effective as of the date the bill was INTRODUCED, which was September 13, 2021. There would be an exception for sales under binding contract that meet certain requirements.

Perhaps the most concerning section of the Ways & Means proposal centers on Grantor Trusts and their subset Intentionally Defective Grantor Trusts (IDGTs). Currently, a Grantor can structure an Irrevocable Trust so that it is taxed to the Grantor for income tax purposes, but not included in the Grantor's estate at death. The Ways & Means proposal shifts assets of a Grantor Trust into the Grantor's estate at death. The proposal also treats sales between the Grantor and the Grantor Trust as third-party sales, in essence recognizing gain at the time of the sale. Lastly, transfers out of Grantor Trusts would be treated as taxable gifts. Luckily, current Grantor Trusts would be grandfathered. By most accounts, the effective date for this dramatic shift in estate inclusion would occur for Grantor Trusts created or funded on or after date of enactment. This change would impact a variety of trusts, most notably the Grantor Retained Annuity Trust (GRAT), Qualified Personal Residence Trust (QPRT), and Insurance Trust (ILIT).

While it is unknown if the House Ways & Means Committee intended to impact these trusts, practitioners and taxpayers are left scrambling for ways to alleviate this possibly devastating and counterintuitive aspect.

While it is too early to know precisely what legislation will pass, if any passes at all, and what the full ramifications will be, many are wondering what can be done now to preserve their estate planning goals. Perhaps the easiest and quickest solution for high-net-worth households is to utilize the current available gifting powers.[3] It may be wise to consider making substantial gifts for the benefit of spouses and other family members before the end of the year to utilize the $15,000 annual exclusion and the exclusion for medical and educational expenses. For estates above $5 million, consider using all available trust vehicles that are valid today for planning purposes. The change in estate and gift tax exemptions would not take place until January 1, 2022, and the law contains no "clawback" provision. The change in the Grantor Trust rules would take place on the date of the law's enactment. Particularly problematic is the effect on Insurance Trusts (ILITs), as most of these trusts are Grantor Trusts by nature. Gifts are made to the ILIT to pay for insurance premiums on the Grantor's life. Where applicable, it may be necessary to convert existing ILITs to Non-Grantor Trusts and provide for alternative funding mechanisms to provide for insurance premiums. Well-drafted Grantor Trusts have built-in mechanisms to toggle status from Grantor Trust to Non-Grantor.

While much is uncertain about the House Ways & Means legislation, what is certain is that taxpayers and their advisors must remain nimble in adapting to potential changes. [4] A good deal more is contained in the Ways & Means proposal, which is far beyond the scope of this advisory. As significant as what the legislation could include is what the proposal excludes. The aforementioned step-up in cost basis in a decedent's estate was left unchanged, as was the $10,000 limitation on the deductibility of state and local taxes, the so-called SALT limitation. Interestingly, the proposal contains significant funding for the IRS budget, leading wise taxpayers to conclude that many more audits are on the horizon. While precise details are unknown, now is the time for thoughtful consultation with your Fiduciary Strategist and Planners to protect your estate plans.

For more information, please contact your advisor.

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Sources and endnotes:

1 - Surviving the Death Tax: 2021 Proposals May Challenge Estates, Key Private Bank.

2 - There is also an additional 3.8% surtax on net investment income over the threshold amount. This is applicable at all marginal rates. Effective for individual filers with AGI of $200,000; and married filing jointly with AGI of $250,000.

3 - Only one state, Connecticut, currently imposes a gift tax. Note that many states have a stand-alone estate tax.

4 - At present there is a small window to use the trust vehicles that are available today. If executed before any law enactment, one will be well prepared for the future. Some examples of these vehicles are Dynasty Trusts, Spousal Lifetime Access Trusts, and Domestic Asset Protection Trusts. See Tina Myers analysis here: Three Estate Trusts for the Uncertain Legislative Future. These trusts are excellent trusts to use for future planning even if not drafted as Grantor Trusts for income tax purposes.

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